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Oil Field Pitfalls: Avoiding Environmental Liabilities Affecting Petroleum and Natural Gas Drilling and Production

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OIL FIELD PITFALLS--AVOIDING ENVIRONMENTAL LIABILITIES AFFECTING PETROLEUM AND NATURAL GAS DRILLING AND PRODUCTION

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I. KEY APPLICABLE FEDERAL AND STATE ENVIRONMENTAL PROGRAMS

A. PENDING REVISIONS TO ADPC&E REGULATION NOS. 18 AND 19:

* Note exemptions
* De Minimis cut-offs

B. CERCLA:

1. General:

Congress enacted CERCLA in 1980 to provide EPA with the authority to clean up hazardous waste sites and otherwise protect public health and the environment from releases of hazardous substances. The enactment of CERCLA gave EPA the authority to require responsible parties to undertake immediate cleanup activities without prolonged litigation to determine how the ultimate liability will be apportioned. If responsible parties resist or are incapable of conducting the cleanup, EPA or the state may act with federal funds and seek cost recovery later. The program covers a broad range of releases of hazardous substances into the environment - from accidental one-time spills to continuing or intentional releases.

The CERCLA scheme is applicable to a "release" of a "hazardous substance" from a "facility." These key terms have been interpreted to have an incredible breadth. Consequently, CERCLA actions have involved both inactive and active facilities, buildings and unimproved properties.

CERCLA can impact a property or company transfer, whether through a loan foreclosure, simple acquisition, or otherwise, in three main ways:

(a) persons who acquire contaminated property may be liable for cleanup costs;

(b) persons who acquire a company that sent hazardous substances to a facility that has had a release (and the facility cannot properly deal with the problem); or

(c) CERCLA permits EPA to place a lien on contaminated property to allow the government to recoup its cleanup costs when the property is sold.

What is a hazardous substance?

(a) Key petroleum exclusion ("petroleum, crude oil or any fraction thereof") cases:

* Wilshire Westwood Associates v. ARCO, 881 F.2d 801 (9th Cir. 1989) (gasoline containing additives covered)

* United States v. U.T. Alexander, C.A.G--86--267 (unreported) (crude oil tank bottoms covered)

* Cose v. Getty Oil, 4 F.3d 700 (9th Cir. 1993) (crude oil tank bottoms not covered) (sedimentary materials and water separated out containing chrysene)

* United States v. Western Processing Co., 761 F. Supp. 713 (W.D. Wash. 1991) (gasoline and diesel tank bottoms outside exclusion because contaminated with metals such as nickel, cadmium, that flaked off tank walls)

* Southern Pacific Transportation Co. v. California, 790 F. Supp. 983 (C.D. Cal. 1991) (benzene listing under 1990 CAA Amendments doesn't petroleum exclusion)

* KN Energy, Inc. v. Sinclair Oil Corp., Haz. Waste Lit. Rep. (Andrews) 29191 (D. Wyo. Aug. 24, 1995) (petroleum refinery liable under CERCLA for releasing small amounts of trichlorofluoromethane, ethylene chloride, trichloroethan, tricloromethane, and methylene chloride which are not normally found in petroleum products and therefore are not exempted by the petroleum exclusion)

* Caterair Int'l Corp. v. LCL Transit Co., No. 94-C-1049, 1995 WL 348045, Haz. Waste Lit. Rep. (Andrews) 28957 (N.D. Ill. June 5, 1995) (prior operator of truck refueling and maintenance facility was not liable under CERCLA for release of benzene, ethylbenzene, toluene, xylene ("BETX") and polynuclear aromatic hydrocarbons ("PNAs") since these substances are indigenous components of crude oil and therefore encompassed with the petroleum exclusion).

(b) Other relevant cases:

* Jastran v. Phillips Petroleum Co., 844 F. Supp. 1139 (G.D. LA. 1994) (produced water not "hazardous substance," "pit sludges" are)

(c) "Arranger" cases dealing with recyclables and deposit return:

* United States v. Cello-Foil Products, Inc., 848 F. Supp 1352 (W.D. Mich. 1994) (purchases of solvent delivered in drums were not subject to CERCLA arranger liability when they returned empty drums containing solvent residues to vendor in exchange for deposit)

* United States v. Summit Equipment & Supplies, Inc., 805 F. Supp. 1422 (N.D. Ohio 1992) (sellers of used equipment at blind auction sales were liable as arrangers even if they did not know that purchaser intended to use the equipment for scrap metal

* Chesapeake and Potomac Telephone Co. v. Peck Iron & Metal Co., 822 F. Supp. 322 (E.D. Va. 1993) (indirect seller of batteries to shredding facility liable as "arranger")

Note possible Superfund legislative recycling revisions.

* United States v. Peterson Sand & Gravel, 806 F. Supp. 1346 (N.D. Ill. 1992) (sale of fly ash not "arrangement)

(d) Other

* Grand Truck Western Railroad Co. v. Acme Belt Recoating, Inc., 859 F. Supp. 1125 (W.D. Mich. 1994) (easement holder not liable under CERCLA as "owner")

Also note "used oil" cases.

2. Potentially Responsible Parties:

Section 107(a) of CERCLA provides that response costs may be recovered from four classes of persons:

(a) the owner or operator of the site or facility; Note--Leaseholders of property; United States v. Argent, 21 ERC 1354 (D.N.M. 1984) (lessor held liable under CERCLA Section 107 as "owner"); United States v. South Carolina Recycling and Disposal, 653 F. Supp. 984 (D.S.C. 1984) (lessee of site which sublet it to another liable as "owner"); United States v. Northernaire Plating Co., 670 F. Supp. 742 (W.D. Mich. 1987) (lessee was found to be an "operator" of a facility);

(b) any person who owned or operated the site or facility at the time of the hazardous substance disposal;

(c) any person who arranged to have his or her own waste taken to the site or facility for disposal or treatment; and

(d) any person who transported wastes for disposal or treatment to a site he or she selected.

3. Other Possibly Responsible Parties:

In addition to the four classes of potentially responsible parties defined above, the courts have interpreted the phrases "owner and operator" and "person who arranged for disposal" to include the following parties whose connection with the hazardous substances is less "direct." Examples of such parties include the following:

(a) A secured creditor whose activities go beyond simple "indicia of ownership primarily to protect his security interests," but extend to participation and oversight in the management of facilities. See United States v. Maryland Bank and Trust Company, 632 F. Supp. 573 (D. Md. 1986) (bank which foreclosed on a mortgage and took possession of the property liable as in "owner"); see also United States v. Mirabile, 15 ELR 20994 (E.D. Pa. 1985) (bank which participated in day-to-day operations at the site prior to foreclosure sale may be liable as "operator"), but see United States v. Fleet Factors Corp., 901 F.2d 1550 (11th Cir. 1990) (lender "participates in management" if it takes part in the financial affairs of the facility, even if the lender is not involved in the day-to-day operation or management of the facility, i.e. if there is a "capacity to influence" the hazardous waste activities of the debtor); Bergsoe Metal Corp. v. East Asiatic Company, No. 89-35397, slip op. (9th Cir. Aug. 9, 1990) (creditor must as a threshold matter, exercise actual management authority before it can be held liable for action or inaction which results in the discharge of hazardous wastes - merely having the power to get involved in management, but failing to exercise it, is not enough); Guidice v. BFG Electroplating and Manufacturing Co., 30 ERC 1665 (Sept. 1, 1989) (court denied summary judgment to a bank that in 1982 foreclosed on an industrial property later found to be contaminated - held that by taking a Sheriff's deed to the property, bank forfeited its right to assert the secured creditor exemption);

On June 5, 1991, the EPA proposed a regulation intended to clarify the applicability of CERCLA to various activities associated with financing (56. Fed. Reg. 28798). Specifically, the rule interprets the security interest exemption under CERCLA (found at CERCLA § 101(20)(A)) which exempts from CERCLA liability persons whose "indicia of ownership" in a facility are held primarily to protect the security interest, provided they do not participate in the management of the facility. Pressure from Congress and the financial services industry was responsible for EPA's action. The primary reason of this pressure was the financial industries' concern about the previously cited U.S. v. Fleet Factors Corp. decision. Dicta in this decision suggests that a secured creditor may be liable, without being an operator, if he participates in the management of a facility "to a degree indicating a capacity to influence the corporations treatment of hazardous waste." The court's opinion did not discuss what level of participation would be sufficient to support the

inference that a security holder's involvement could influence operational decisions concerning a facility's treatment of hazardous waste. To reduce the uncertainty, EPA issued this proposed rule to specify the range of permissible actions that may be undertaken by the holder of a security interest within the bounds of the Section 101(20)(A) security interest exemption.

On April 23, 1992, EPA issued its long-awaited regulations on the liability of secured lenders for environmental clean-ups under the Agency's Superfund program.[1] These regulations adopted with very little change the proposal that EPA published almost a year ago.[2] The regulations attempt to define the actions that secured lenders may take with respect to contaminated commercial facilities without incurring Superfund liability.

The exposure of lenders to Superfund liability arises primarily out of the fact that the statute imposes responsibility for clean-ups on the current "owner or operator" of a facility, and any former "owner or operator" of the facility at the time hazardous substances were disposed of. The statute defines the phrase "owner or operator" in very broad terms, but secured lenders are specifically excluded by the following language:

> [The] term ["owner or operator"] does not include a person, who, without participating in the management of a facility, holds indicia of ownership primarily to protect his security interest[.][3]

EPA's lender liability regulations are designed to provide holders of security interests with a map for remaining within the bounds of the security interest exemption. They allow a lender to engage in a broad range of activities in the course of protecting a security interest in a facility subject to Superfund.

The EPA lender liability regulations clearly state that no action by a covered lender prior to the creation of the security interest can be considered evidence of "management participation" for purposes of determining Superfund liability. EPA states that such pre-loan activities are irrelevant for determining whether a covered lender has participated in the facilities management after the time that indicia of ownership are held primarily to protect the security interest. Such clarification should provide a level of comfort to those lenders who either require, or themselves undertake certain environmental investigatory actions at facilities serving as collateral for a loan. However, in the atypical situation in

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[1] 57 Federal Register 18344 (published April 29, 1992), to be codified as 40 C.F.R. § 300.1100. The regulations also address the liability of governmental entities which acquire property involuntarily.

[2] 56 Federal Register 28798 (published June 24, 1991).

[3] 42 U.S.C. § 9601(20)(A).

which a financial institution either requires or performs remediation at a facility prior to financing, Superfund liability as an "operator" is still a theoretical possibility. Appropriate care should therefore be taken.

The EPA lender liability regulations also generally define what type of financing relationships are encompassed by the security interest exemption. This is obviously a critical issue for the lender to consider prior to the consummation of a transaction. Two key terms define the relationships encompassed by the EPA lending regulations.

First, the term "indicia of ownership" is defined to include evidence of a security interest, evidence of an interest in a security interest, or evidence of an interest in real or personal property securing a loan or other obligation, including any legal or equitable title to real or personal property acquired incident to foreclosure and its equivalents. EPA states that the exemption protects a broad range of transactions, and it covers all transactions in which ownership indicia are held primarily to protect a security interest regardless of the transaction's type, form or the nomenclature given to it. Traditional security interest in real property, such as mortgages, liens and deed of trust (covering both title-theory and lien-theory jurisdictions) cover security interests under the EPA lender liability regulations, and are considered to be indicia or evidence of ownership in property held primarily to secure a loan or other obligation.

In addition, EPA states that so-called "lease financing" transactions, which are common financing transactions for equipment and other types of personal property are also treated as security interests. The type of lease financing transactions clearly encompassed include those in which the lessor does not initially select the leased property. Instead, this is done by the lessee or third party. Further, during the initial lease or any re-lease, the lessor does not control the daily operation and maintenance of the property. Such transactions typically include national bank lease financing, leveraged leases, and single investor leases.

Second, whether a person's ownership indicia brings it within the definition of "owner or operator" under Superfund is dependent upon its classification as "primarily to protect the security interest." Therefore, the ownership interest must be maintained primarily for the purpose of, or primarily in connection with securing payment or performance of a loan or other obligation (a security interest), and not an interest in property held for some other reason. In general, a transaction that give rise to a security interest is one that provides the holder with recourse against real or personal property of the person pledging the security; the purpose of the interest is to secure the payment of money, the performance of a duty, or some other obligation.

The EPA notes that mortgages, deeds of trust, liens and title held pursuant to lease financing transactions may be encompassed. Security interest may also arise from transactions such as sale-and-leasebacks, conditional sales, installment sales, trust receipt transactions and certain factoring agreements.

The term "holder" as used in the EPA lender liability regulations is considered to include the initial holder (such as the loan originator) and any subsequent holder, such as a successor in interest, subsequent purchaser on the secondary market, loan guarantor, surety, or other person who maintains indicia of ownership primarily to protect the security interest. The terms "indicia of ownership" held "primarily to protect a security interest" do not include evidence of interest in the nature of an investment in a facility, or an ownership interest held primarily for any reason other than as protection for security interest. Therefore, when a lender holds indicia of ownership in a facility primarily for investment purposes as opposed to assuring repayment of a loan, the exemption will not apply. Further, the EPA lender liability regulations do not encompass circumstances in which a lender or any person acts as a trustee, or in a non-lending capacity, or has any interest in a facility other than as provided in the rule. Therefore, trust department functions are not protected by the security interest exemption.

Diligent lenders typically reserve the right to undertake certain inspection activities at a facility serving as collateral. In the alternative, the loan documents may specifically provide the lender the right to require the borrower to undertake certain activities designed to ensure the facility's continued compliance with the relevant federal and state environmental protection programs. If the lenders' actions are deemed to constitute "participation in the management of the facility" the Superfund security exemption is forfeited. Therefore, in order to ensure that cautious lenders do not abstain from such desirable activities, the EPA lender liability regulations clearly state that "participation in the management of the facility" means actual participation in the management or operation of the facility. It does not include the mere capacity or unexercised right or ability to influence facility operations. The EPA lender liability regulations also supply a list of activities commonly undertaken by lenders that the agency considers to be consistent with holding ownership indicia primarily to protect a security interest. The nonexclusive list includes:

(1) requiring the borrower to clean up the vessel or facility during the term of the security interest;

(2) requiring the borrower to comply or come into compliance with applicable federal, state, and local environmental statutes or regulations during the term of the security interest;

(3) securing or exercising the authority to monitor and inspect the vessel or facility (including on-site inspections);

(4) monitoring the borrower's business or financial condition during the term of the security interest; or

(5) requiring the borrower to comply with any warranties, covenants, conditions, representations, or promises.

Note that the activities identified in the EPA lender liability regulations are not the only ones that may be undertaken by the lender without voiding the exemption.

The lender is also permitted to undertake loan workout activities. This term generally includes those actions by which a holder, at any time prior to foreclosure and its equivalents, seeks to prevent, cure, or mitigate a default by the borrower or obligor; or to preserve, or prevent the diminution of the value of the security. A nonexclusive list of activities deemed to be encompassed within this term include:

(1) restructuring or renegotiating the terms of the security interest;

(2) requiring payment of additional rent or interest;

(3) exercising forbearance;

(4) requiring or exercising the rights pursuant to an assignment of counts;

(5) requiring or exercising the rights pursuant to an escrow agreement pertaining to amounts owing to an obligor;

(6) providing specific or general financial or other guidance; or

(7) exercising any right or remedy the holder is entitled to by law or under any warranties, covenants, conditions, representations or promises from the borrower.

The EPA lender liability regulations recognize that foreclosure and possession of property for purposes of sale or liquidation is often the only remedy the lender may have to secure the performance of an obligation. The security interest is not forfeited upon foreclosure, purchase at foreclosure sale or related activities as long as certain specific requirements are met.

In general, a foreclosing lender must seek to sell or otherwise divest itself of foreclosed-on property in a reasonably expeditious manner using whatever commercially reasonable means available or appropriate taking all facts and circumstances into account. The lender cannot, consistent with the exemption, reject or refuse offers for the property that represent fair consideration for the asset. Specifically, the lender may foreclose, liquidate, sell, or wind up operations and continue the enterprise in order to protect the value of the secured asset without incurring Superfund liability, unless the security holder fails within twelve months following foreclosure to list and advertise the property for sale. The lender is also prohibited from refusing a "bona fide offer." Note, however, that defenses to CERCLA liability such as the secured creditor exemption are not transferable to a subsequent purchaser.

Several recent federal court decisions have cited or utilized the lender liability regulations. One decision is Waterville Industries v. Finance Authority of Main, 948 F.2d 549 (1st Cir. 1993). The litigation stemmed from efforts to clean up two waste water lagoons at a defunct textile mill in Waterville, Main. First Hartford Corp. sold the mill property to Waterville Textile Development Corp., a quasi-public corporation unconnected with the appellee in this case, and then leased it back. Loans in connection with the project were made to First Hartford by Society for Savings and secured by mortgages. FAME, an instrumentality of the state of Main, guaranteed the loans. In 1980, First Hartford defaulted on the loans. FAME assumed First Hartford's obligations and received an assignment of the mortgages. On March 14, 1980, FAME became the title holder of the property. On that same day, FAME leased the property back to First Hartford. Under the lease, First Hartford had the option to purchase for $1.00. FAME was deemed protected by the secured creditor exemption.

In another case involving the lender liability regulations, the Bank of Montana-Butte ("Bank") has filed a motion for summary judgment against ARCO, contending that the Bank is not liable to ARCO for Superfund contribution at the Montana Pole and Treating plant. Atlantic Richfield Co. v. Qaas, No. CV-90-75-BU-PGH (D. Mont. pending). ARCO filed its contribution action on the basis that the Bank's management and liquidation of plant property subjected the Bank to Superfund liability for: influencing the management of hazardous substances during the Bank's ownership, operation, and control of the plant; selling contaminated plant equipment at an auction; and operating the plant in a manner that prompted Montana to sue the Bank for operating an unlawful storage facility. The Bank counters that an opinion letter which it received from U.S. EPA exonerates it from liability. EPA's letter applies the standards contained in U.S. EPA's proposed lender liability rule. The trial court has not yet ruled on the motion.

The court in United States v. McLamb, 5 F.3d 69 (4th Cir. 1993) addressed the secured creditor exemption. In 1979, the Wachovia Bank & Trust ("Trust") took a security interest in land that included a tract known as "Potters Pits" as collateral for a loan it had made to one Auto Skipper. After Skipper defaulted, Trust bought the land as sole bidder at a foreclosure sale. Several months later, Trust sold the land to the McLambs. Contamination was later discovered on the property. Trust was named in a contribution suit by several defendants.

The plaintiffs argued that Trust was liable for CERCLA or Superfund contribution because it became and outright "owner" of the site when it bought the property because it did not act in a commercially reasonable manner after it took title. They claimed that Trust failed to inform them of a 1976 oil spill and cleanup operation before selling the property. The appeals court rejected the argument based on the fact that Trust bought the property only to protect its security interest because there were no other potential buyers. The court noted that the record indicated no investment or profit motive for acquiring the property. It further noted that Trust did not engage in a bidding war at the foreclosure sale and almost immediately placed it on the market. It is also important to note that the court

declined to rely on lender liability regulations to support its findings, ruling that Trust qualified for the statutory exemption. However, the court did say the result probably would have been the same if it had relied on EPA's interpretation of the exemption.

A United States magistrate in McGuire v. Sigma Coatings, Ed. La. Civ. No. 91-2076 ruled that a financial institution which took over a borrower's property before Superfund was enacted into law and leased it to an alleged polluter had no CERCLA liability. He made the ruling in recommending dismissal of defendant FINA Oils' contribution counterclaim against plaintiff Whitney National Bank and the latter's CERCLA breach of lease action stemming from the oil company's alleged contamination of property leased from the bank.

The magistrate rejected the oil company's argument that the bank should be liable to it because the bank did not stop FINA at some point from polluting the property. It stated that the bank was not consulted by the oil company with regard to how its business should have been conducted. It had no capacity to exert control over their handling of hazardous substances or waste. He stated that the EPA does not expect a secured lender to inspect the property before taking a lien thereon in order to qualify for the secured creditor exemption.

Unfortunately, on February 4, 1994, U.S. Court of Appeals for the District of Columbia Circuit Court by a 2-1 vote, struck down the lender liability regulations in CMA v. EPA, CA DC No. 9201314. The court held that EPA lacked authority to adopt a legislative rule that defines who is liable under CERCLA. The regulations therefore doe not have force as a legislative rule. The court did not comment on the substance of the regulations. This invalidation of course recreates some of the previous uncertainty lenders faced. However, some of the previously cited decisions favored lender activities without relying on the regulations. Courts may continue to look at to the regulations for guidance.

Congress may statutorily amend CERCLA because of the regulations' invalidation. As a practical matter, however, the federal government is unlikely to assert a claim under Superfund against lenders who relied on the lender liability regulations in good faith during the legal challenge. Of course, states or private parties could still seek to impose liability upon such lenders. They may still be reviewed as guidance for when the lender is deemed to have stayed within the secured creditor exemption.

A further concern is whether the lender liability regulations apply retroactively. The EPA, however, has indicated that it will apply to all transactions, thus making it retroactive.

The EPA lender liability regulations were an important step toward clarifying the Superfund security exemption. Certain activities and financial products are clearly encompassed. However, there will obviously be certain non-listed activities or transactions which will require interpretation.

It is also imperative that lenders recognize the limited effect of the EPA lender liability regulations. They offer only EPA's interpretation of select Superfund provisions. While they have (and still may) offer protection against EPA enforcement actions, they may not deter non-governmental entities from pursing private party Superfund contribution actions. Superfund's strict joint and sever liability provisions provide non-governmental entities an incentive to seek contributions from as many parties as possible. Therefore, the EPA lender liability regulations will not remove all Superfund exposure.

The EPA lender liability regulations do not, of course, address the other federal environmental statutes and regulations. Some of the other key federal environmental statutes contain similar security interest exemption language. It is uncertain whether these principles will be analogized to the other statutes. However, in the case of the federal Resource Conservation and Recovery Act Subtitle I underground storage tank provisions, EPA has stated that it will develop similar guidance. Note, that in the case of petroleum underground storage tanks, sophisticated financial institutions are beginning to structure their financing transactions to take advantage of trust funds available in Arkansas and other states to somewhat mitigate the potential liabilities related to this equipment. The impact on relevant Arkansas environmental statutes is even more uncertain.

Lenders must also recognize that statutory environmental liability is not their only concern. Of equal importance, is the possibility that property that is contaminated or on which development cannot take place (i.e., a Corps of Engineers 404 wetland permit cannot be obtained, etc.) can be just as devastating. Therefore, EPA lender liability regulations do not address the potential impact on the collateral's value.

Consequently, it is imperative that diligent lenders continue to develop pre-loan environmental assessment programs. In addition, since specifically authorized by the EPA lender liability regulations, lenders should utilize loan documentation provisions that provide the ability to monitor a facility's condition. Environmental inspection rights or provisions requiring notification of the lender in the event of any EPA/state environmental reports can provide early warning of events or conditions that may continue to impact the value of the collateral. The Arkansas State Bank Department has in fact recently issued a guidance document entitled *Managing Environmental Risk: A Practical Guide* (Dec. 1991) which encourages such actions. Also note that the FDIC has also issued standards addressing environmental risk management that its member banks are expected to meet.

Please note that Congress is still considering various legislative vehicles for providing additional protection for financial institutions (including their trust departments).

4. Arkansas Remedial Action Trust Fund Act:

(No petroleum exclusion).

5. Arkansas Water Pollution Control Act:

(No petroleum exclusion).

C. NATURALLY OCCURRING RADIOACTIVE MATERIALS:

D. RCRA:

Each year, U.S. industries generate substantial quantities of solid wastes as residual materials from basic manufacturing processes. In addition, hundreds of thousands of service industry businesses [ranging from truck terminals (i.e., solvents) to dry cleaners (i.e., TCE)] generate smaller quantities of materials. Among these wastes are hazardous materials that pose present or potential dangers to human health and the environment. Uncontrolled disposal of such wastes on land has already caused significant groundwater contamination in some areas, and threatens eventual pollution at many other disposal sites. Improper storage or management of even small quantities of these materials could jeopardize the value and safety of thousands of active and inactive businesses and properties.

1. Subtitle C of the Resource Conservation and Recovery Act ("RCRA") regulates the generation, transportation, treatment, storage, and disposal of "hazardous wastes." 42 U.S.C. § 6901 et. seq., as amended by Hazardous and Solid Waste Amendments of 1984, November 8, 1984.

2. RCRA primarily addresses active waste treatment, storage or disposal facilities, while CERCLA addresses inactive facilities. However, under the citizen suit provision found at Section 7002 (42 U.S.C. § 6972) and under the imminent hazardous provisions at Section 7003 (42 U.S.C. § 6973), actions for cleanup can be brought against past and present owners or operators of treatment, storage, or disposal facilities. See, e.g., United States v. Price, 523 F. Supp. 1055 (D.N.J. 1981), aff'd, 688 F.2d 204 (3rd Cir. 1982) (past and present owners held liable under Section 7003); United States v. Northeastern Pharmaceutical and Chemical Company, 810 F.2d 726 (8th Cir. 1986) cert. denied, 56 U.S.L.W. 3244, 108 S.Ct. 146 (1987) (shareholders and officers individually held liable under Section 7003); Vermont v. Staco, Inc., 27 ERC 1084 (D. Vt. 1988) (shareholders and officers liable because of having "ultimate authority to control").

3. Operational Requirements:

(a) Identification of hazardous waste:

Note: RCRA exploration and production waste exemption (drilling fluids, produced waters and other wastes "associated" with "C & P." 42 U.S.C. § 6921(b)(2)(A). Also, may still be subject to Superfund? EPA studied this matter and

issued a report to Congress in 1987. EPA's formal regulatory determination was issued in July, 1988 (53 Fed. Reg. 25446). It included:

(1) Produced waters;
(2) Drilling fluids;
(3) Drill Cuttings;
(4) Rigwash;
(5) Drilling fluids and cutting from offshore operations;
(6) Geothermal production fluids;
(7) Hydrogen sulfide abatement waste from geothermal energy production;
(8) Well completion, treatment, and stimulation fluids;
(9) Basic sediment, water, and other tank bottoms from storage facilities that hold product and exempt wastes;
(10) Accumulated materials such as hydrocarbons, solids, sand, and emulsion from production separators, fluid treating vessels, and production impoundments;
(11) Pit sludges and contaminated bottoms from the storage or disposal of exempt wastes;
(12) Workover wastes;
(13) Gas plant dehydration wastes;
(14) Gas plant sweetening wastes for sulfur removal;
(15) Cooling tower blowdown;
(16) Spent filters and backwash assuming that the filter itself is not hazardous and the residue is from an exempt waste;
(17) Packing fluids;
(18) Produced sand;
(19) Pipe scale, hydrocarbon solids, hydrate, and other materials removed from piping and equipment <u>prior to</u> transportation;
(20) Hydrocarbon-bearing soils (contaminated soils);
(21) Pigging wastes from gathering lines;
(22) Certain wastes from subsurface gas storage and retrieval;
(23) Constituents removed from produced waters prior to re-injection or other disposal;
(24) Liquid hydrocarbons removed from production streams;
(25) Gases from production streams;
(26) Materials ejected from a well during blowdown operations;
(27) Waste crude oil from primary operations; and
(28) Light organics volatilized from exempt waste in reserve pits or impoundments

Wastes not included are:

(1) Unused fracturing fluids or acids;
(2) Gas plant cooling tower cleaning wastes;
(3) Painting wastes;
(4) Oil and gas service company wastes;
(5) Vacuum truck and drum rinseate from trucks or drums containing nonexempt wastes;
(6) Refinery wastes;
(7) Liquid and solid wastes generated by crude oil tank bottom reclaimers;
(8) Used equipment lubrication oils;
(9) Waste compressor oil, filters, and blowdown;
(10) Used hydraulic fluids;
(11) Waste solvents;
(12) Waste in transportation pipeline-related pits;
(13) Caustic or acid cleaners;
(14) Boiler cleaning wastes;
(15) Boiler refractory bricks;
(16) Boiler scrubber fluids, sludges, and ash;
(17) Incinerator ash;
(18) Laboratory wastes;
(19) Sanitary wastes;
(20) Pesticide wastes;
(21) Radioactive tracer wastes; and
(22) Drums, insulation, and miscellaneous solid wastes

Certain issues were clarified by EPA in 1993 (58 Fed. Reg. 15284 (March 23, 1993)). Waste derived from treatment of exempt waste remain exempt.

(i) Overview:

To be considered a hazardous waste under RCRA, a material must first fit the definition of "solid waste" - that is, it must be a solid, liquid, or gas that is a discarded material and is abandoned, recycled, or otherwise "inherently waste-like." Although this definition is quite expansive, there are several specific regulatory exclusions and variances that significantly narrow the reach of the RCRA program.

One important type of material excluded from the definition of solid waste is any mixture of domestic sewage and other wastes that passes through a sewer system to a treatment plant. The pre-treatment requirements under the Clean Water Act are intended to regulate the amount and type of materials sent to a sewer. Other materials excluded from the definition of solid waste include: industrial wastewater discharges subject to regulation under Section 402 of the Clean Water Act; irrigation return flows; source, and wholly domestic sewage.

The aspect of the RCRA program that is most difficult to understand is the extent to which secondary materials - such as sludges, spent materials, and byproducts - that are recycled or used to produce other substances, become "wastes" and thus are subject to RCRA. Recycling material by burning it for energy recovery may result in solid waste classification. This classification includes those materials which are used to produce a fuel or are otherwise contained in fuels. In the latter case, the fuel itself is a solid waste. However, commercial chemical products which are listed in 40 C.F.R. § 261.33 are not solid wastes if they are themselves fuels.

Materials that are being reclaimed are solid wastes. According to the definitional section, a material is reclaimed "if it is processed to recover a usable product or if it is regenerated." Examples of reclaimed materials include recovery of lead values from spent batteries and regeneration of spent solvents. Certain recycled materials are specifically deemed not solid wastes when it can be shown that these materials were (1) used or reused as ingredients in an industrial process to make a product; (2) used or reused as effective substitutes for commercial products; or (3) returned to the original process from which they were generated, without first being reclaimed. Obviously, if such materials are not solid waste, they cannot be hazardous waste and consequently are not subject to RCRA regulation.

Potential purchasers of a facility will want to consider what, if any, recycling methods are utilized at the facility. For example, is a printing facility recycling any of its solvents? Note that an understanding of the regulations is important since a potential purchaser may want to confirm that the facility is recycling in compliance with the regulations.

Once it is established that a material is a solid waste, there are two ways in which it can be designated a hazardous waste: It can exhibit one of four characteristics (ignitability, corrosivity, reactivity, or extraction procedure ("EP") toxicity[4]), " or it may be specifically named on

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[4] On March 5, 1990, the EPA signed the Toxicity Characteristic ("TC") final rule, which was designed to modify and expand the EP toxicity test. The TC differs from the EP Toxicity test in two ways:

(1) It expands the list of toxic constituents of concern; and,

(2) It establishes regulatory levels for organic toxicants that are generally obtained by multiplying health-based

one of three lists published in the Code of Federal Regulations (hazardous wastes from nonspecific sources, hazardous wastes from specific sources, and discarded (in their pure form) commercial products or manufacturing chemical intermediates and their off-specification species).

A company generating a listed hazardous waste may petition EPA to "delist" this particular waste. A company seeking to delist a waste must demonstrate that the waste does not possess any of the qualities or components which could justify classifying a substance as a hazardous waste.

(ii) The "Mixture" "Derived-From" Rules:

In order to discourage companies from hiding their hazardous waste by mixing small quantities with larger quantities of innocuous, nonhazardous waste, EPA fashioned the so-called "mixture" rule, which provides that, with certain exceptions, any mixture of a solid waste and a listed hazardous waste is also a hazardous waste. 40 C.F.R. § 261.3 (a)(2)(iv). Thus, if a single drop of a listed hazardous waste is combined with 20,000 gallons of wastewater, the 20,000 gallons of water containing the listed waste is itself a hazardous waste. A mixture of solid waste with a waste exhibiting a hazardous characteristic, however, is hazardous only if the mixture itself exhibits a hazardous characteristic.

The derived-from rule provides that any waste generated from the treatment, storage, or disposal of a listed hazardous waste is itself a hazardous waste 40 C.F.R. § 261.3(c)(2)(i). Therefore, even if a listed hazardous waste is treated so that it no longer presents health concerns, the remaining residue is still subject to hazardous waste regulation unless EPA grants a site specific delisting petition.

On December 6, 1991, the D.C. Court of Appeals held EPA's mixture and derived-from rules invalid because EPA had not provided adequate notice or an opportunity for public comment. Shell Oil Co. v. EPA, 950 F.2d 741 (D.C. Cir. 1991). The Court of Appeals reviewed the history of the rulemaking proceeding and concluded that mixture and derived-from rules were

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"chronic toxicity reference levels" by a dilution - attenuation factor which is generated using a ground-water fate and transport model.

EPA estimates that 99% of new wastes coming into the hazardous waste management program due to the TC rule will be industrial wastewaters. The new provision will also expand the type and amount of wood treating wastes considered "hazardous wastes".

a substantial departure from the proposals originally published by EPA which the public could not reasonably have anticipated. Since the court held the regulations invalid on procedural grounds, it did not attempt to reach the question whether the regulations exceeded EPA's statutory authority.

Apparently recognizing EPA's concerns that invalidation of the mixture and derived-from rules could open significant loopholes in the regulation of hazardous waste, the court suggested that EPA could readopt the mixture and derived-from rules on a temporary basis under the "good cause" exemption in the Administrative Procedure Act.

On February 18, 1992, EPA readopted the mixture and derived-from rules on an interim basis, but the new regulations contained an unprecedented one-year sunset provision. 57 Fed. Reg. 7628 (published March 3, 1992). Under this sunset provision, the temporary regulation expires on April 28, 1993. In the meantime, EPA is required to undertake rulemaking proceedings to adopt new regulations that will replace the interim mixture and derived-from rules.

Immediately after the decision in Shell Oil, EPA filed a petition for rehearing and a request for clarification that the court's judgment was not retroactive. EPA argued that retroactive application of the judgment invalidating the mixture and derived-from rules could have serious adverse effects on numerous pending enforcement proceedings. The court of appeals denied the Agency's petition for rehearing and denied the motion for clarification of the court's judgment without comment.

When EPA readopted the mixture and derived-from rules under the "good cause" exemption, it included in the public notice a formal statement of its view that the Shell Oil decision should not be applied retroactively. 57 Fed. Reg. 7630-31. This statement of the Agency's position of non-retroactivity was substantially identical to the argument it had made to the court of appeals when it unsuccessfully sought clarification of the judgment.

Although EPA's readoption of the mixture and derived-from rules appears to have reinstated the rules as valid regulations on a prospective basis, it is unclear whether EPA's argument against retroactive application of Shell Oil should be viewed as persuasive in any pending enforcement proceeding. Stated more simply, it is unclear at this point whether any valid mixture and derived-from rules existed prior to February 18, 1992.

The decision in Shell Oil has significant implications for state law because the hazardous waste

regulations in many states incorporate by reference large portions of EPA's RCRA Subtitle C rules, including the mixture and derived-from rules. In Arkansas, for example, Section 3(a) of the Hazardous Waste Management Code provides that:

> The following regulations promulgated by the U.S. Environmental Protection Agency are hereby adopted as provisions of [the Arkansas Hazardous Waste Management Code] as though set forth herein line for line and word for word . . . .

Title 40 Code of Federal Regulations [Parts 260-266, 268, and 270, with certain limited exceptions and modifications]. The EPA regulations incorporated by reference into the Arkansas Hazardous Waste Management Code include the mixture and derived-from rules.

In the wake of the Shell Oil decision, EPA and ADPC&E have taken the position that the state mixture and derived-from rules continue to be valid even though the court of appeals invalidated the EPA regulations upon which the state rules had been based. They argue that the states have independent authority to adopt their own hazardous waste regulations and the adoption of state mixture and derived-from rules constitutes a valid exercise of the state rulemaking authority. EPA and ADPC&E point out that the procedural flaw in the federal regulation, i.e., inadequate notice and opportunity to comment, is not a problem with the state mixture and derived-from rules because the states gave clear notice and ample opportunity to comment upon the terms of the federal rules that they proposed to incorporate into state law. In addition, EPA and ADPC&E contend that a valid federal mixture and derived-from rule has always been in effect because they view Shell Oil as having only prospective effect, and EPA readopted the mixture and derived-from rules before the court of appeals mandate officially invalidated the original regulations.

The position taken by EPA and ADPC&E on this question is subject to serious question. It is true, of course, that ADPC&E has the authority to adopt its own hazardous waste regulations, independent of any rules adopted by EPA. In this instance, however, ADPC&E did nothing more than incorporate by reference an admittedly invalid federal regulation. The ADPC&E's principal motivation for incorporating the federal regulation by reference was to make state law essentially identical to the underlying federal law. In light of this motivation, it would seem that any defect in the underlying federal law should be imputed to the state law as well. Moreover, since ADPC&E was anxious to adopt state rules essentially identical to the underlying federal regulations, the notice and opportunity to comment at the state level on the merits of the mixture and derived-from rules was largely meaningless.

EPA and ADPC&E argue that any defect in the state mixture and derived-from rules that might have existed prior to February 18, 1992, was cured when EPA readopted the federal mixture and derived-from rules under the "good cause" exemption. According to this argument, state law now incorporates by reference the newly adopted, and presumably valid, federal mixture and derived-from rules. The general rules governing incorporation by reference, however, suggest that this argument is incorrect.

Where one statute or regulation adopts the terms of another statute or regulation by specific reference, it is generally held that the adopting statute or rule is not affected by subsequent amendment or repeal of that statute or rule that was adopted by reference, e.g., Bolar v. Cavaness, 271 Ark. 69, 607 S.W.2d 367 (1980); Annot., 168 A.L.R. 627 (1947). Under this rule, it would seem that ADPC&E's adoption of a state mixture and derived-from rule by specific reference to the original EPA rules could not be cured by EPA's subsequent readoption of the federal mixture and derived-from rules.

It should be noted that one state court has already addressed the effect of the Shell Oil decision on state law and concluded that the state rules were also invalid. Equidae Partners v. Oklahoma State Department of Health, Case No. C-91-532 (Dist. Ct. Washington County, Oklahoma, decided January 16, 1992) (invalidating the Oklahoma derived-from rule, which had incorporated by reference the EPA derived-from rule).

EPA eventually proposed two options to replace the mixture and derived-from rules. The proposal was published May 20, 1992 in the Federal Register. 57 Fed. Reg. 21450-21522. It was eventually withdrawn. However, it is probably helpful to analyze this previous proposal as the agency will likely consider similar concepts again.

The focal point of the proposal was the two modifications to the definition of hazardous waste. The first proposal, the concentration-based exemption criteria ("CBEC"), would provide an exit from Subtitle C regulation based on the concentration of hazardous constituents in a listed hazardous waste, waste mixtures, treatment residues and media (including soil and ground water) contaminated with listed wastes. CBEC would eliminate some low-risk wastes from hazardous waste regulation, but it would do so largely within the parameters of the existing hazardous waste regulatory system.

EPA's second option would have more broadly altered the existing structure of hazardous waste regulation. The second exemption, based on the toxicity characteristic (the Expanded Characteristics Option or "ECHO") would eliminate: (1) the mixture rule; (2) the derived-from rule; and (3) hazard-

ous waste listings. Entrance into and exit from the hazardous waste regulatory system would be based entirely on the four hazardous waste characteristics. While this latter option would simplify the existing regulatory system, it would also expand the existing toxicity characteristic ("TC"), thereby potentially sweeping a variety of new wastes into the regulatory system.

While the proposal would exempt various wastes from hazardous waste regulation, those substances would still be subject to regulation as solid wastes under RCRA. Also, although the proposal clearly addresses listed hazardous waste, EPA has left ambiguous its impact on characteristic hazardous waste. These proposals were not acted upon.

(iii) Hazardous Waste Identification Rule Proposed:

EPA recently proposed another modification to RCRA's waste identification rule. It was signed on the eve of the November federal government shutdown.

The Hazardous Waste Identification Rule ("HWIR") proposal is the most recent step in this lengthy response to the 1991 court decision in Shell Oil v. EPA. In this landmark case, the Washington, D.C., Court of Appeals determined that the EPA had failed to follow the Administrative Procedures Act ("APA") when crafting the "mixture and derived from" rules. As a result of this decision, these rules were vacated which could have resulted in huge quantities of waste exiting the hazardous waste system.

The recently proposed rule is considered to be a regulatory relief measure in that it is estimated to result in $80 million in savings to the regulated community; however, the proposal would also add another layer of requirements to an already complex set of rules. Under the proposed rule, to "exit" the hazardous waste system, a generator would have to:

(a) test (and retest) the waste in accordance with a sampling and analysis plan;
(b) meet the treatment standards provided under the land disposal restrictions ("LDRs") program (although an exemption from LDRs is proposed as well);
(c) provide public notice of the generator's intent to exit or exempt a waste; and
(d) provide a separate notice to appropriate authorities of the intent to exempt a waste.

(iv) Used Oil (the special exception):

The 1984 amendments to RCRA required EPA to propose whether to identify or list used automobile and truck crankcase oil by November 8, 1985, and to make a final determination as to whether to identify or list any or all used oils by November 8, 1986. On November 29, 1985 (50 Fed. Reg. 49258), EPA proposed to list all used oils as hazardous waste, including petroleum-derived and synthetic oils, based on the presence of toxic constituents at levels of concern during and after use. Also on November 29, 1985, EPA proposed management standards for recycled used oil (50 Fed. Reg. 49212) and issued final regulations incorporated at 40 C.F.R. Part 266, Subpart E, prohibiting the burning of off-specification used oil fuels in non-industrial boilers and furnaces (50 Fed. Reg. 49164). Marketers of used oil fuel and industrial burners of off-specification fuel are required to notify EPA of their activities and to comply with certain administrative requirements. Used oils that meet the used oil fuel specification are exempt from most of the 40 C.F.R. Part 266, Subpart E regulations.

On November 19, 1986, EPA reversed itself and issued a decision not to list as a hazardous waste used oil that is recycled (51 Fed. Reg. 41900). At that time, it was EPA's belief that the stigmatic effects associated with a hazardous waste listing might discourage the recycling of used oil, thereby resulting in increased disposal of used oil in uncontrolled manners. EPA stated that several residues, wastewaters, and sludges associated with the recycling of used oil may be evaluated to determine if a hazardous waste listing for these residuals was necessary, even if used oil was not listed as a hazardous waste. EPA also outlined a plan that included making a determination of whether or not to list, as a hazardous waste, used oil that is disposed and promulgation of special management standards for recycled oil.

EPA's decision not to list used oil as a hazardous waste based on the potential stigmatic effects was challenged by the Hazardous Waste Treatment Council, the Association of Petroleum Re-refiners, and the Natural Resources Defense Council.

On October 7, 1988, the Court of Appeals for the District of Columbia found that EPA acted contrary to law in its determination not to list used oil under RCRA § 3001 based on the stigmatic effects. (See Hazardous Waste Treatment Council v. EPA, 861 F.2d 270 (D.C. Cir. 1988) (HWTC II). The court ruled that EPA must determine whether to list any used oils based on the technical criteria for waste listings specified in the statute and in EPA's implementing regulations.

On May 20, 1992 (57 Fed. Reg. 21524), the EPA decided that the current regulatory structure controlling the management of used oil destined for disposal provides adequate controls so that used oil will not pose a substantial threat to human health or the environment. However, it decided not to list used oil as a hazardous waste. Used oils exhibiting one or more of the characteristics of hazardous waste and which are destined for disposal continue to be regulated as hazardous wastes in accordance with all applicable subtitle C regulations, except when stored in RCRA subtitle I underground storage tanks. Mixtures of used oils and listed hazardous wastes are listed hazardous wastes, and used oil mixed with a characteristic hazardous waste must be managed as a hazardous waste if it still exhibits a characteristic. Such mixtures must be managed in accordance with all applicable Subtitle C hazardous waste regulations.

EPA also created an exemption for used oil filters at 40 C.F.R. § 261.4(b)(13) which identifies solid wastes that are not hazardous wastes. This exemption is limited to non-terne-plated used oil filters which have been drained to remove used oil. As a practical matter, if an oil filter is picked up by hand or lifted by machinery and used oil immediately drips or runs from the filter, the filter should not be considered to be drained. EPA is requiring that filters qualifying for the exemption first have the used oil removed using one of the following gravity hot-draining methods:

(1) puncturing the filter anti-drain back valve or the filter dome end and hot-draining;

(2) hot-draining and crushing;

(3) dismantling and hot-draining; or

(4) any other equivalent hot-draining method which will remove used oil. Then, once the used oil is removed, it can be recycled (as can the scrap metal).

(b) Duties and Obligations of Hazardous Waste Generators:

Each of the generator's requirements are discussed below. A generator's duties and obligations under most state laws (including Arkansas) are similar to the federal regulations discussed here, although generators should consult the applicable state regulations. Since Arkansas obtained delegation of the federal RCRA Subtitle C program, it has adopted through incorporation by reference in the Arkansas Hazardous Waste Management Code ("AHWMC") most of the federal provisions. However, some of the AHWMC provisions do vary from the federal regulations.

EPA defines a "generator" at 40 C.F.R. § 260.10 as:

> any person, by site, whose act or process produces hazardous waste identified or listed in Part 261 of this chapter or whose act first causes a hazardous waste to become subject to regulation.

Section 1004(15) of RCRA defines "person" as:

> an individual, trust, firm, joint stock company, corporation, (including a government corporation), partnership, association, State, municipality, commission, political subdivision of a State, or any interstate body.

A person who is not normally a generator can incur generator liability by engaging in certain activities. For example, a waste generator who cleans up a spill, or an independent contractor who cleans out a tank and thereby produces hazardous waste residue, will be considered a generator and be subject to RCRA regulations. Although EPA has stated that it will respect agreements between private parties that assign generator duties, it reserves the right to hold both the original generator, and any other person whose act first gives rise to RCRA regulation, jointly and severally liable for compliance with the generator's obligations at each facility.

*Hazardous waste identification

Hazardous waste generators must determine whether a material is a hazardous waste by applying the methods for hazardous waste identification described above. If the waste is not listed, the generator must determine if it exhibits hazardous waste characteristics by either testing the waste or "applying knowledge of the hazardous characteristic of the waste in light of the materials or the processes used." Likewise, the generator should determining whether the hazardous waste is specifically excluded from RCRA regulation.

*Obtaining EPA identification number

Every generator who determines that he is producing hazardous waste must obtain an EPA Identification Number, pursuant to 40 C.F.R. Section 262.12. EPA Identification Numbers are obtained by applying to the EPA Administrator, using EPA Form 8700-12. It is illegal for a generator to treat, store, dispose of, transport, or offer for transportation hazardous waste without having obtained the Identification Number. Likewise, it is illegal for a generator to offer his hazardous waste to transporters or TSD facilities that have not received such a number.

*The manifest system

In March, 1984, in conjunction with the U.S. Department of Transportation, EPA published a Uniform Hazardous Waste Manifest to ensure that hazardous waste destined for off-site treatment, storage, or disposal ("TSD"), actually reaches its destination and to keep track of its travels along the way. Generators of hazardous waste are responsible for ensuring that a manifest has been properly prepared before the hazardous waste is removed from the site.

The manifest itself requires that the generator supply the following information: (1) the manifest document number; (2) the generator's name, address, telephone number, and EPA Identification Number; (3) every transporter's name, telephone number, and EPA Identification Number; (4) the designated and alternate TSD facilities' name, address, telephone number, and EPA Identification Number; (5) the U.S. Department of Transportation description of the waste, including the proper shipping name, hazard class, and Identification Number; (6) the number and type of containers used to transport the waste; (7) the total quantity of each hazardous waste by weight or volume; (8) the waste handling coder and (9) the generator's certification that the hazardous waste has been properly described, classified, packed, marked, labeled, and is in proper condition for transportation.

The manifest must be used whenever a generator transports, or offers to transport hazardous waste for off-site treatment, storage, or disposal. The generator is required to designate on the manifest the one TSD facility that is permitted to receive the waste. An alternate facility may be included in case an emergency prevents the designated facility from receiving the waste. If neither of these facilities can accept the waste, the generator must either designate another facility or have the transporter return the waste.

In the event the generator does not receive a signed copy of the manifest from the TSD facility within 35 days after the waste is accepted by the original transporter, the generator must contact the transporter and the TSD facility to determine whether the waste and manifest were ever received. If the signed manifest is not received within 45 days, the generator must submit an Exception Report to the EPA Regional Administrator that must include a copy of the manifest and a cover letter explaining the generator's efforts to locate the hazardous waste and the results of those efforts.

*Pre-transport requirements

In addition to preparing manifests for the shipment of hazardous waste off-site, generators are also responsible for packaging, labeling, marking, and placarding the waste prior to its transportation. EPA has adopted U.S. Department of Transportation regulations regarding these procedures, which are found at 49 C.F.R. Parts 172, 173, 178, and 179.

*Accumulation time

EPA's regulations allow a generator to accumulate hazardous waste on-site for up to 90 days without having to obtain a TSD facility permit or without having interim status, whether the generator plans to treat or dispose of the waste on-site or plans to ship it off-site to a TSD facility, as long as certain regulatory requirements are met. In order to store hazardous waste for this 90-day period a generator must:

(1) Place the waste in containers and comply with 40 C.F.R. Part 265, Subpart I, or place the waste in tanks and comply with 40 C.F.R. Part 265, Subpart 5;

(2) Clearly mark on the outside of the container the date upon which the period of accumulation begins;

(3) Clearly label the container or tank "Hazardous Waste"; and

(4) Comply with personnel training, facility prevention and preparedness, contingency plan, and emergency response procedures set forth at 40 C.F.R. Part 265, which apply to interim-status TSD facilities.

This 90-day period may be extended by EPA for up to 30 days upon a showing of unforeseen, temporary, and uncontrollable circumstances. In addition, "small quantity generators" (described below) have up to 180 days to accumulate their waste.

*Recordkeeping and reporting requirements

EPA's regulations require that hazardous waste generators keep three difference types of records. First, the generator must keep a copy of all manifests signed by the designated TSD facility that received the waste for a period of three years from the date the waste was accepted by the initial transporter. Second, copies of any Exception Reports or biennial reports (discussed below) must also be retained for three years. Finally, the records of all test results, waste analyses, or other date upon which a hazard-

ous waste determination was made must be kept for a least three years from the date the waste was last sent to a TSD facility. If EPA is the regulatory authority within a state, hazardous waste generators must submit biennial reports to EPA.

*Special requirements for small quantity generators

The EPA has established less rigorous regulations for conditionally exempt small quantity waste generators -- those generators who produce no more than 100 kilograms of hazardous waste in a calendar month. Generators of acute hazardous waste may generate no more than 1 kilogram of acute hazardous waste in a calendar month to qualify for small quantity generator status. Conditionally exempt small quantity generators' hazardous wastes are not subject to regulation under 40 C.F.R. Parts 124, 252 through 255, 268 and 270. Generators who produce more than 100 but less than 1,000 kilograms per month are also exempt from certain Sub-Title C requirements (i.e., they have the ability to accumulate wastes up to 180 days).

The records and documents required to be maintained by these provisions can provide useful information to a potential purchaser. Therefore, these documents and records should be obtained and reviewed.

(c) Treatment - Storage - Disposal issues:

Any facility that treats, stores, or disposes of hazardous waste, and that is not eligible for an exemption, must obtain a permit from EPA or an authorized state agency. Permits incorporate those minimum national substantive standards that are set out in 40 C.F.R. Part 264. The comprehensive regulatory scheme of Part 264 includes general standards applicable to virtually all TSDs: identification numbers, personnel training, facility security, and routine inspection; rules for preparedness and prevention (such as communication systems and fire-control equipment); requirements for contingency plans and emergency procedures; manifest, recordkeeping and reporting requirements; standards governing the closure, post-closure care, and monitoring of disposal facilities; and requirements for financial assurance regarding facility closure and post-closure care, and liability coverage for third-party property damage and bodily injury.

In addition to these general requirements, there are specific permitting standards that govern the design, performance, and operation of specific categories of waste management units: containers, tanks, incinerators, waste piles, surface impoundments, land treatment units, landfills and other containers.

As a result of the statutory changes in 1984, all applicants for landfill or surface impoundment permits must now submit a health assessment addressing the potential for public exposure to releases from those units. Air emissions at TSDs will be regulated, and EPA is authorized to add other appropriate conditions to TSD permits to protect human health and the environment, even if the conditions are not specifically imposed by Sub-Title C regulations.

EPA is issuing pursuant to a staggered time frame, regulations prohibiting the land disposal of all hazardous wastes that have not first been treated to minimize their toxicity, unless an interested party demonstrates to EPA that "to a reasonable degree of certainty, . . . there will be no migration of hazardous constituents from the disposal unit or injection zone for al long as the waste remains hazardous." EPA rulemaking in this area has established that treatment standards (which may be expressed as specified treatment technologies or as concentrations of restricted materials in a waste or waste extract) will be set on the basis of the "best demonstrated available treatment technology;" which, among other criteria, has been "demonstrated" through the operation of a full scale facility and provides "substantial treatment" of the waste.

Most facilities that produce, market, and burn hazardous waste-derived fuel are required to notify EPA of their activities. EPA is directed to promulgate standards to be used in drafting permits for these facilities. Initial rulemaking in this area has banned outright the burning of hazardous waste fuel and contaminated used oil in nonindustrial boilers (for example, those located in apartment and office buildings, schools, and hospitals) unless the boilers comply with interim status incinerator standards and the notification and storage requirements applicable to industrial burners of waste fuels. Furthermore, it is now illegal to transport hazardous waste fuels without an accompanying manifest.

Eventually, every operating hazardous waste management facility, regardless of its age or operating history, must have a final RCRA permit issued in compliance with the Part 264 permitting standards. Congress recognized, however, that the administrative task of issuing permits to every hazardous waste management facility would consume many years. Accordingly, RCRA grants "interim status" to those facilities that (1) were in existence on November 19, 1980 (or on the effective date of a change under the Act that rendered them subject to the requirement of obtaining a permit); (2) complied with certain notification requirements; and (3) initially applied for a final RCRA permit in a timely fashion. Until a permit is finally granted or denied at the administrative level, an interim status facility is allowed to continue to operate as long as it meets certain self-executing requirements, set out in 40 C.F.R. Part 265. A land

disposal facility lost its interim status on November 8, 1985, unless it submitted its complete application for a full permit and certified that it was in compliance with the interim status groundwater monitoring and financial assurance requirements.

Section 3004(u) provides that all RCRA permits - including those issued for storage units and for postclosure care - must require "corrective action for all releases of hazardous waste or constituents from any solid waste management unit at [the]... facility...regardless of the time at which the waste was placed in such unit." These permits must also contain enforceable assurances that the permittee will complete the cleanup. EPA has interpreted this corrective action authority broadly.

An increasingly important part of the RCRA program is the use of groundwater protection standards to measure the adequacy of remedial actions. Once it has been demonstrated that there is contamination due to releases from a RCRA facility, the EPA Regional Administrator or a state director is obligated to craft a permit that will contain specific pollutant concentration limits that may not be exceeded at the boundary of the waste management area. Those concentration limits may be derived from any one, or a combination, of three sources: They may represent "background levels"; they may be the Safe Drinking Water Act primary drinking water standards; or they may be alternate concentration limits ("ACLs"), determined not to pose a substantial present of potential hazard to human health or the environment, taking into consideration a number of factors. Because the use of background levels often dictates selection of a remedy that is extremely costly, if not infeasible, and because there are relatively few substances regulated under the Safe Drinking Water Act, in most significant RCRA groundwater cleanup cases, there are powerful incentives for a permittee to make an ACL demonstration.

4. An individual or company acquiring an interest in a facility containing a hazardous waste management unit, such as a lagoon, surface impoundment or tank, should consider the following:

(a) the facility must be permitted under RCRA and be operated in full compliance with such permit; and

(b) corrective action to clean up the full extent of any groundwater contamination at the facility must be instituted, whether or not it resulted from hazardous waste management activities.

5. Because the generator of hazardous waste initiates the waste management cycle, the generator is a central figure in the "cradle to grave" regulatory scheme. Hundreds of thousands

of businesses such as dry cleaners, printing shops and vehicle maintenance centers produce varying amounts of hazardous wastes and are therefore classified as "generators" in the RCRA scheme. Generators are obligated to comply with a number of requirements which include proper hazardous waste manifesting, storage and identification. The failure to comply with these requirements can subject the generator to civil and criminal penalties. Of equal importance, the failure by a company to comply with these basic RCRA requirements may be a sign of past improper waste management practices and necessitate greater scrutiny on the part of anyone considering the acquisition of such operation.

6. Why is a basic understanding of RCRA important? Anyone advising a business or participating in the sale or purchase of a business or property should have a basic familiarity with RCRA. The reason for this is several fold. First, and most obvious, non-compliance can lead to severe penalties. Second, non-compliance with RCRA, even the simple requirements, is an indication that this facility may be a risky investment. Third, a failure to use proper RCRA disposal or treatment facilities can mean that this facility may face CERCLA exposure in the future as renegade disposal sites are discovered.

E. CLEAN WATER ACT:

Status of Arkansas stormwater program.

F. UNDER AND ABOVE GROUND STORAGE TANK PROGRAMS:

1. See appended chapter.

2. The Arkansas Tank Program:

UST concerns came to the attention of the Arkansas state legislature in 1987. Former state representative John Lipton chaired a Joint Interim Committee to review the impact of the upcoming federal regulations on UST owners and operators. The Joint Interim Committee heard testimony concerning the high cost of insurance, potential for loss of retail motor fuel outlets in rural areas and the need for the state of Arkansas to establish its own technical standards along with a state trust fund. The Committee ultimately recommended that such legislation be drafted and introduced in the 77th General Assembly.

In 1989, the Arkansas legislature passed Acts 172 (Ark. Code Ann. §§ 8-7-801 to 813) and 173 (Ark. Code Ann. §§ 8-7-901 to 909) without a dissenting vote. Section 8-7-802 provides the Arkansas Department of Pollution Control and Ecology ("ADPC&E") with the statutory authority to promulgate a regulatory program. Section 8-7-803 provides that this regulatory program shall be as identical as possible to the federal regula-

tions. The ADPC&E, in April, 1995, obtained complete delegation of the federal program. Consequently, a UST owner or operator will typically deal with the ADPC&E rather than the EPA. Section 8-7-802 also provides the ADPC&E with the authority to perform corrective actions at UST sites and recover such costs from the owner or operator. An annual registration fee is imposed on both USTs and certain above ground storage tanks (that hold between 1,320 and 30,000 gallons).

The purpose of former Act 173 is twofold. First, the trust fund provision (§ 8-7-905) allows eligible petroleum UST owners or operators to satisfy a portion of the financial responsibility requirements. Second, it creates a permanent fund (with a 15 million dollar cap) to reimburse eligible petroleum UST owners and operators or injured third parties for a specified portion of corrective action or property damage or bodily injury. Note that unlike many state trust funds, certain above ground storage tanks (that hold between 1,320 and 30,000 gallons) may utilize the fund.

The Petroleum Storage Tank Trust Fund is capitalized by a yearly registration fee and a $.002 per gallon petroleum environmental assurance fee. The Arkansas legislature in the 1995 regular session, passed legislation (Senate Bill 688) that allows bonds to be issued (pledging the .002) to provide further financial strength for the trust fund.

The trust fund covers and provides reimbursement for corrective action costs above $25,000 and up to $1,000,000 per occurrence. The scope of coverage for third-party property damage and bodily injury claims also begins at $25,000 and terminates at $1,000,000. The trust fund statute was amended in 1991 by Act 65 to provide reimbursement <u>without</u> a deductible for owners and operators for short-term testing or monitoring required by the federal or state regulations <u>if</u> the tank is found <u>not</u> to be the source of the release. The intent was to provide all UST owners and operators in the vicinity of the petroleum release, an incentive to cooperate in finding the true source of the release.

UST or AST owners or operators submit claims for reimbursement to the ADPC&E Regulated Storage Tank Division ("RSTD"). The trust fund Advisory Committee reviews the recommendation of the ADPC&E staff regarding eligibility of all or part of a claim and renders a decision. The trust fund will reimburse costs only if proof is provided that:

-- corrective action has adequately addressed the release;

-- all annual Arkansas UST or AST registration fees have been paid;

-- the owner or operator cooperated with the ADPC&E staff;

-- the owner or operator was in substantial compliance, with all state and federal laws and regulations relating to ASTs or USTs; and,

-- timely notice of the release was given.

The § 8-7-907 prerequisites for granting reimbursement provide a significant incentive for owners and operators to comply with the regulations, thereby eliminating or at least minimizing leakage or spillage in the future.

UST owners or operators should understand that it is critical they maintain compliance with the relevant federal and state statutes and regulations to ensure trust fund eligibility. What constitutes "substantial compliance" is not defined in either the statute or the regulations. The ADPC&E staff consequently has some discretion in deciding what constitutes substantial compliance in their recommendation to the Advisory Committee. The ADPC&E position as to what constitutes substantial compliance seems to be evolving. Only informal ADPC&E memoranda limited in scope address the issue. Note that even if the staff disagrees whether a given UST or AST is in substantial compliance, the Advisory Committee can exercise its own judgment.

Both Subchapter 8 (§§ 8-7-801 to 813) and Subchapter 9 (§§ 8-7-901 to 909) require the ADPC&E to promulgate regulatory packages to implement the key provisions of each program. The ADPC&E promulgated Regulation No. 12 to not only incorporate virtually the entire federal program, but to set forth the details of the state program, especially the reimbursement process.

Regulation No. 12 addresses a range of UST-related topics including ADPC&E facility access for inspection, registration/licensing fees, fund eligibility, reimbursement claims procedure and reimbursement application review. A major portion of the regulation is devoted to the licensing of storage tank installers and tank testers. The regulation makes clear that for any claim against the trust fund, the associated release must have been discovered and reported after February 22, 1989. The ADPC&E is currently circulating extensive proposed revisions to Regulation No. 12.

UST and AST releases can potentially cause property damage and/or bodily injuries. Consequently, a UST or AST release can potentially trigger lawsuits for recovery of damages. The trust fund can reimburse, subject to a $25,000 deductible, third-party property damage and/or bodily injuries caused by AST or UST releases.

The trust fund statute and ADPC&E Regulation No. 12 provide that judgments for damages that fit within the scope of the terms "property damage" and/or "bodily injury" are reimbursable. In addition, both the trust fund statute and the ADPC&E Regulation No. 12 have set up a procedure by which ADPC&E storage tank staff can recommend to the Advisory Committee (which also oversees this reimbursement process) a settlement of third-party claims if the anticipated cost of a trial (if a judgment was obtained) would exceed a settlement amount. Because the vast majority of UST and AST releases causing property damage and/or bodily injury are not insured, the role of the trust fund in facilitating settlement or reimbursing a judgment of valid claims is critical.

The Trust Fund reimburses not only third parties, but also the eligible owner/operator for at least part of her required "corrective action." The regulation contains fairly detailed instruction as to the form of the application, required receipts, and definitions of "allowable" and "reasonable" costs. As with third-party reimbursement, the corrective action reimbursement approval process flows from the ADPC&E staff to the Advisory Committee to, ultimately, the Arkansas Pollution Control and Ecology Commission.

In addition to Regulation No. 12, the ADPC&E RSTD has recently published informal, yet strongly suggested, guidelines to further assist owners/ operators in the corrective action reimbursement process. Because Regulation No. 12 allows reimbursement only for "reasonable" costs incurred to correct a release, the guidelines are intended to provide insight into the costs the ADPC&E will deem reasonable and, therefore, reimbursable.

The guidelines offer quite specific information concerning the selection of equipment (lease versus buy), the calculation of a consultant's profit, and even limits to the percentage ownership of consultants/vendors by owners/operators so as to avoid conflicts of interest that could jeopardize reimbursement. A matrix of reasonable and customary charge for a typical clean-up is provided, comparing Arkansas rates to Louisiana and Tennessee. Finally, a series of one-page EPA publications titled "Controlling UST Cleanup Costs" is attached to the guidelines.

In summary, the Arkansas Storage Tank Program is in reality an accumulation of law from five sources: federal statutes (RCRA, CERCLA, etc.), federal regulations, states statutes (petroleum storage tank trust fund statutes), state regulations (No. 12), and ADPC&E guidelines. It cannot be emphasized enough that the UST/AST owner/operator must comply with <u>all applicable</u> law at each appropriate step in the process.

Otherwise, the availability of the trust fund to offset the associated costs of a release may be jeopardized if not forfeited.

An article providing an in-depth analysis of storage tank trust funds is found at, Wright, In Storage Funds We Trust: An Analysis of Their Role in Protecting the Environment and Small Businesses, 13 U.A.L.R. L.J. 417 (1991).

3. Third-Party Property Damage and Bodily Injury Claim Issues:

As previously described, some of the state petroleum storage tank trust funds provide coverage for third-party property damage and/or bodily injury claims. Most of the state trust fund statutes and regulations do not clearly specify how the third-party claim reimbursement process works. For example, a number of state trust funds simply provide coverage if a judgment is obtained against the owner or operator. The judgment must be for damages encompassed by the terms "property damage" and "bodily injury." Whether or not, for example, certain alleged damages such as "mental distress" constitute "bodily injury" for trust fund purposes is an open question.

A number of trust funds allow the storage tank owner or operator to settle the third-party claim and obtain reimbursement if the state environmental agency or reviewing committee determines that it is in the best interest of the trust fund (i.e., proceeding to trial will result in a larger amount).

A related issue usually arises shortly after the discovery of petroleum contamination at a facility. Some state environmental agencies will require the storage tank owner or operator to enter into a consent administrative order ("CAO") to ensure timely investigatory and corrective action efforts. The CAO will often include Findings of Fact stating that the UST is the source of a petroleum release. Counsel should carefully scrutinize and revise the CAO to ensure that they do not jeopardize the inevitable third-party property damage or bodily injury claim defense against suits brought by adjacent or nearby landowners. The state environmental agency should, of course, be somewhat sympathetic since there is not a strict need for an admission of certain facts, and they may, in fact, ultimately have to fund the payment of such third-party claims with trust fund monies.

Another related issue involves the negotiation of access agreements. Often the UST or AST owner or operator must obtain access to adjoining or nearby properties for placement of investigative or remediation equipment to address the release. Both the adjoining or nearby landowner and UST/AST owner or operator must carefully consider a variety of issues in negotiat-

ing the access agreement. These include admission of liability, insurance, repairs once the work is completed (for example, is a "patched" parking lot adequate?), interference with continued use of the property, etc. In Arkansas for example, the ADPC&E may (through Ark. Code Ann. § 8-7-807(c)) use certain authorities to obtain access to a property if it is denied in certain circumstances. The legality of these statutes is untested in the courts.

Plaintiffs' attorneys often face interesting issues. On the one hand, they have an incentive to allege in their pleadings that the storage tank owner did not strictly comply with the relevant federal or state regulations in an attempt to advocate punitive damages. Yet, pushing this issue may not be helpful to the plaintiff if a storage tank owner that is attempting to convince the state environmental agency personnel that he or she should be eligible for trust fund reimbursement (i.e., is the UST/AST in "substantial compliance?"). Noncompliance storage tank owners without access to the trust fund may be unable to satisfy a judgment, leaving the winning plaintiff without recovery.

State environmental agencies are also beginning to grapple with the reimbursement of third-party property damage and bodily injury claims. As mentioned, the reimbursement procedures are often unclear. In addition, the scope of the terms "property" damage and "bodily" injury is subject to various interpretations. Parties settling third-party property damage and bodily injury claims must consider the state environmental agencies views of these definitions. For example, a defendant storage tank owner would want to ensure that the settlement clearly reflects and documents the fact that damages suffered by plaintiff fall within the scope of the terms "property damage" and "bodily injury" as defined by the agency. State environmental agency personnel are often uncomfortable with their developing role as claims adjusters. Failing to coordinate with state environmental agency personnel could result in the denial for reimbursement of some or all third-party claims.

The scope of the terms "property damage" and "bodily injury" will be important. The federal regulations provide that these terms are defined by state law. State common law, however, does not typically consider whether items such as access fees (i.e., monies paid to a landowner to allow a temporary placement of wells) constitute "property damage." Further, are costs expended to preserve the value of the property (i.e., remote sensing devices for temporarily abandoned houses) within the scope of the term property damage? Certainly, these costs may constitute corrective action expenses. However, there will be a number of instances in which the storage tank owner is, or will be, expending one million dollars on the corrective action side of the trust fund program. Therefore, the storage tank

owner may have an incentive to classify a number of costs as third-party property damage or bodily injury claims. These issues must be considered, to the extent possible, early in the third-party claim resolution process.

Arkansas attorneys representing either UST/AST owners or operators or third-party plaintiffs seeking property damage and/or bodily injury claims must recognize the critical role of both the ADPC&E RSTD and Legal Division staff in addressing these issues. Both as a legal and a practical matter, they play a key role in the resolution of corrective action and third-party property damage and/or bodily injury claims. In the case of third-party claims, the ADPC&E staff will recommend to the trust fund Advisory Committee whether or not they believe the proposed settlement between the plaintiff and the UST or AST owner or operator is in the best interest of the trust fund. Consequently, all parties should ensure that the ADPC&E staff is consulted at the earliest point at which it appears a settlement is beginning to materialize. Note that a settlement agreement should, of course, have a clause making it conditional that the third-party property damage and/or bodily injury claim is approved by the trust fund Advisory Committee.

It is also important to recognize that in the case of third-party property damage and/or bodily injury claims, the Attorney General's staff plays a role. The Arkansas legislature in 1993 amended the trust fund statute to state that any UST or AST owner or operator receiving a claim must give written notice of it to the ADPC&E not later than 60 days after service of summons. Ark Code Ann. § 8-7-908(d)(1). The ADPC&E is then required to notify the Attorney General who has the right to intervene in the lawsuit. Payment of the third-party claim can be denied if the UST or AST owner or operator fails to give ADPC&E the required notice. The Arkansas Attorney General's staff appears to now be intervening, as a matter of course, in the relevant lawsuits. Consequently, they will also play a role in resolving these claims through litigation or settlement.

The drafting of a settlement agreement involving the resolution of third-party property damage and/or bodily injury claims should consider a variety of issues. A recent Arkansas example is illustrative. A settlement agreement included a typical merger clause indicating that cash remitted to a plaintiff settled all claims. However, in the same settlement agreement, the UST owner committed to demolish two houses and pave two parking lots. The ADPC&E staff took the position that the funds for demolishing one of the houses and paving one of the parking lots actually constituted "corrective action" costs as opposed to a third-party property damage claim. The staff indicated that these activities resembled corrective action costs despite the merger clause. Therefore, the terms of the settlement agreement should be carefully considered in light of trust

fund issues. Ambiguous settlement issues should be discussed with the staff, and ambiguous language resolved.

4. RCRA Statutory Causes Of Action:

RCRA (42 U.S.C. § 6972) may provide a site owner or operator or an adjoining landowner with the opportunity to recover from a third party for property damage resulting from USTs. This statute allows a private party to bring a citizen suit to compel remediation of the contaminated site. Such a cause of action may be needed if a current UST owner or operator is requesting reimbursement from a former owner or operator for the cost of addressing a leak or spill. Thus, if the current owner or operator can establish that another party is responsible for the contamination in question, the costs of cleaning up the site might be borne by that other party.

A recent Ninth Circuit case has potentially broadened the use of the RCRA citizen suit provision. In KFC Western, Inc. v. Meghrig, the plaintiff, a Kentucky Fried Chicken franchisee, had purchased a service station property from the defendants in 1975 to establish a restaurant. In 1988, during the course of improving the property, KFC found the soil was contaminated with constituents of refined petroleum products (lead and benzene). Los Angeles governmental agencies forced KFC to stop construction and clean up the site. KFC spent $211,000 to remove the contaminated soil, and then sued the prior owners under RCRA to recover these costs.

The federal district court dismissed the suit, ruling that RCRA provided only a "public" restitutionary remedy that only the government could use. On KFC's appeal, the Ninth Circuit reversed, stating: "It would be unfair and poor public policy to interpret Section 6972(a)(1)(B) [of RCRA] as barring [private] restitution actions." The Court made clear that private plaintiffs are entitled to recover cleanup costs incurred by the plaintiff for past contamination caused by a prior owner. In so holding, the Court dismissed the contention of the prior owners that there was no "imminent and substantial endangerment" to the environment, as required by RCRA, at the time the suit was filed.

This case is important because it provides present owners of property contaminated with petroleum a potential federal cause of action to recover cleanup costs. In contrast to the common law causes of action, which can present evidentiary and procedural problems, liability under RCRA is relatively simple to establish. Basically, the plaintiff need merely establish that the prior owner owned the property when releases occurred. Moreover, under RCRA, the plaintiff is entitled to recover all attorney fees incurred in bringing the action.

The other edge of this sword should not be ignored. Someone selling a property with a UST where petroleum contamination is discovered years later might be held liable for substantial cleanup costs. The adoption by the states of "risk-based" cleanup standards will reduce, but not eliminate, this potential liability. The KFC Western case reinforces the wisdom of obtaining complete environmental releases from the buyer when selling properties with USTs.

The decision by the Ninth Circuit in is controlling law in California, Nevada, Arizona, Washington, Oregon, Idaho, Montana, Alaska and Hawaii. The decision also is likely to be highly influential in courts throughout the United States when addressing the right of private parties to sue for cleanup costs under RCRA.

G. ADPC&E REGULATION NO. 1:

H. ASBESTOS:

1. Federal OSHA:

Revised standards for occupational exposure to asbestos in the general, construction, and shipyard industries. 59 Fed. Reg. 40964. New worker protection, notice, etc. standards.

2. Arkansas Asbestos Abatement Regulations:

I. ARKANSAS SOLID WASTE MANAGEMENT:

Note comprehensive revisions to ADPC&E Regulation No. 22 addressing both commercial and non-commercial landfill standards.

II. SPECIFIC COMMERCIAL TRANSACTIONS AND RELATIONSHIPS:

A. PURCHASE AND SALE OF IMPROVED AND UNIMPROVED REAL PROPERTY:

Real estate purchases may present unexpected environmental liabilities if there are sources of contamination on the property. Under CERCLA (and state counterparts) and the Resource Conservation and Recovery Act (along with other federal environmental statutes) purchasers, even without knowledge of the property's contamination, can be ordered to pay for the cleanup. The reasons for such expansive liability are the previously discussed responsible party terms such as "owner" and "operator" found in the federal (and sometimes state) statutes such as CERCLA. Contamination on the property is not the only concern. A purchaser taking title to a facility will be responsible for

expending funds to address violations or upgrade equipment that is required by the federal and state environmental regulatory programs. For example, a buyer purchasing a facility with the Clean Water Act National Pollution Discharge Elimination System ("NPDES") permit will be required to take whatever action is necessary to ensure that the effluent discharge is within permit limitations. Similarly, the purchaser of a grocery convenience store utilizing underground storage tanks will be required to upgrade these systems by the applicable deadlines. Whether or not the seller is required to inform the buyer of the responsibility he or she may be accepting is the subject of a recent Arkansas Supreme Court decision. A recent Arkansas Supreme Court decision indicated that the seller may not have a responsibility to provide buyer with notice of the federal and state underground storage tank upgrade requirements. See generally Wright, In Storage Tank Funds We Trust: An Analysis of Their Role in Protecting the Environment and Small Business, 13 U. Ark. Little Rock L.J. 417 (1991).

B. LEASING:

Lessors and Lessees often negotiate and draft leases without carefully considering how environmental risks and liabilities are to be allocated between the parties. Lessors or lessees who fail to account for environmental risks in lease agreements could face unplanned expenditures for remediating contamination and/or complying with federal or state environmental regulatory requirements. The federal and state statutes and regulations can potentially impose obligations on both lessors and lessees of improved and unimproved real properties. These federal and state statutory and regulatory programs can effect leasing activities in three ways:

(1) exposure of lessors and lessee to environmental liability (For example, see the previous CERCLA discussion noting that lessors or lessees can be held responsible for contamination even though activity is limited to passive property ownership);

(2) prevent lessor or lessee from performing under the lease; and

(3) impair lessees's utilization of the property.

The regulatory programs related to underground storage tanks offers an example of the need to consider environmental responsibilities prior to entering into a lease. Petroleum refiners and wholesalers often lease facilities with underground storage tanks to independent retailers. The RCRA Subtitle I provisions (identical provisions are found in the Arkansas Underground Storage Tank statutes) liability provisions place responsibility for violations on both the owner (even if passive) or operator. Therefore, the lessor

refiner or wholesaler may be held responsible for underground storage tank regulatory violations even if the lease provides that lessee must maintain compliance with these programs. A discussion of this issue in the underground storage tank context can be found at Wright, In Storage Tank Funds We Trust: An Analysis of Their Role in Protecting the Environment and Small Business, 13 U. Ark. Little Rock L.J. 417, 425 (1991).

In order to minimize potential environmental liabilities, the lessor or lessee must identify, evaluate and manage environmental risks prior to entering into a lease and during the lease period. A discussion of the use of environmental assessments and the allocation of environmental responsibilities is found in sections IV and V of this outline. However, both the lessor and lessee's perspective on these issues can be summarized at this point.

The lessor's principle interest will be to maintain the value of the property and avoid environmental liability. Therefore, lessor should require that the lessee comply with all relevant federal and state statutes and regulations. The lessee should also be required to explain in detail his or her proposed use of the property. The lease should require that the lessee inform (and receive permission) for the proposed use of the property. The lessor will, of course, need a lease provision that provides him or her the opportunity to assess the lessee's use of the premises. Finally, the lessee should be required to inform or copy lessor on any notices or correspondence that he provides to federal or state environmental agencies (i.e., spill reports, etc.).

In contrast, the lessee must ensure that he or she does not take possession of property which will subject it to some type of environmental liability. Therefore, in many instances, the lessee may find it important to perform an investigation so as to establish an environmental baseline for the property at the start of the lease. The lessee should receive assurances from the lessor in the form of covenants and warranties of the property's condition. Further, the lessee should not allow an overly cautious lessor to unnecessarily restrict his or her use of the property with overreaching environmental covenants.

C. OIL/GAS PROVISIONS:

1. Lease:

Implied duty of restoration by lessee? Bond v. Sanchez, 289 Ark. 582, 715 S.W.2d 444 (1986).

2. Mineral and Royalty Conveyances:

Key potential for multiple "owner," or operators under CERCLA and related laws.

Review
--authority to or actual control
--ownership rights (holding some of the "sticks" in the bundle of rights. (Right of control?)

Note Ouaker v. United States, 681 F. Supp. 280 (W.D. 1988). Surface owner held to be "owner' under Section 311 of the federal Clean Water Act and therefore he was responsible for cleanup of oil containment pit. The pit was used by a previous lessee. Pit or pond used by mineral owner?

3. Note oil/gas lessee may want to limit its "ownership" and "operating" control over pre-existing contaminated surface locations. Define area precisely of surface and subsurface rights. Exclude certain area.

III. ENVIRONMENTAL SITE ASSESSMENTS/CONTRACTUAL ALLOCATION OF LIABILITIES:

A. Environmental Assessment:

(1) Overview:

An EA provides information to parties relating to contamination and/or environmental regulatory compliance of improved and unimproved properties. The objective of the EA is to not only identify potential environmental contamination or regulatory compliance issues, but to avoid the need for guarding against or negotiating around the unknown. Data gathered and interpreted in the EA will provide the parties vital information for decision making and adoption of negotiation postures.

Information provided by the EA may also be needed for the effective use of some of the other environmental issue resolution tools discussed in this article. For example, a seller requested to warrant the absence of certain contaminants and substances should be reluctant to provide such a provision for a given area unless there is some level of confidence that none are present. Unless the seller has comprehensive knowledge regarding the previous uses of this portion of the property, an EA by the seller or both parties may be prudent prior to agreeing to such a warranty.

Likewise, a buyer considering the purchase of a facility with USTs such as a gasoline convenience store or truck terminal may want to assess the regulatory compliance status of this equipment. USTs in substantial compliance with the relevant environmental regulations may be eligible for reimbursement for the remediation of post-acquisition petroleum leakage or spillage pursuant to the Arkansas Petroleum Storage Tank Trust Fund.[1]

A buyer or lessee may use an EA to attempt to identify and quantify environmental risks related to the property or facility. Both recognize that the federal and state environmental statutes may impose remediation obligations on them for contaminants discovered after closing. Besides the simple identification of substances or contaminants that may or may not require remediation, the optimal result for an initial or subsequent EA is the quantification of the cost to perform such remediation.

Both the seller and the purchaser sometimes have an incentive to establish a rough baseline through an EA. A baseline is an attempt to document the environmental conditions in existence at the time of closing against which future changes can be judged. A seller of a facility or property might use an appropriate baseline to defend against an allegation that hazardous substances discovered after closing were generated by the former owner rendering him or her a CERCLA responsible party.[2]

Also consider a lessee preparing to execute a lease for a gasoline grocery convenience store or a bulk motor fuel plant. If the facility will be utilized for a similar use, the lessee might be taking a serious risk if a baseline is not set prior to acquisition of the leasehold. Otherwise, the lessee may not have the information to counter lessor's argument that contamination existing at the end of the leasehold term was caused by lessee's use. Obviously, the lessor may also wish to set a baseline prior to the beginning of the lease term so that the lessee cannot claim that subsequently discovered motor fuel spillage or leakage was pre-existing. As a practical matter, as discussed below, Arkansas facilities with certain petroleum USTs and above ground storage tanks ("ASTs") may be eligible for some cleanup cost reimbursement from the Petroleum Storage Tank Trust Fund if certain statutory prerequisites are met.

Equally important, the EA should be structured to provide the buyer and lessee the projected future cost of compliance with any applicable environmental regulatory programs. As an example, consider a lessee contemplating entering into a long-term lease agreement for several gasoline/grocery convenience stores with USTs in which he or she will be contractually allocated environmental regulatory compliance responsibilities. The prudent lessee will quantify the costs to meet the RCRA Subtitle I UST leak detection/upgrade requirements over the next several years.[3] Similarly, a prospective purchaser or lessee of a building might consider what the Clean Air Act chlorofluorocarbon phase-out will cost if the air conditioning system must be modified.[4]

Regulatory compliance concerns are not limited to improved properties. For example, a prospective purchaser of unimproved property in certain suspect areas may wish to determine if it is subject to the FWPCA Wetland 404 permitting requirements by

obtaining a delineation from the United States Corps of Engineers or making such determination itself.

(2) Scope:

The scope of the EA will vary with the type of property or facility. It is imperative however, that attorneys remind their clients that the relationship between the value of a facility and the cost of an EA are not symmetrical. A $75,000 dry cleaning facility with ground water contamination is a much more serious threat than a properly operated $10 million manufacturing facility. Nonetheless, commercial realities will in many instances dissuade the client from significant assessment efforts on low value properties. Governmental programs such as the Arkansas Petroleum Storage Tank Trust Fund may help ameliorate some of the concerns related to properties with USTs and ASTs and save EA costs in certain instances.

The actual activities that should be performed during the EA is a combination of the parties' perspective and the potential activities that have or may have taken place on the property or facility. From a potential purchaser or lessee's perspective, for example, there are standard information items such as current and past property use and governmental record reviews. While the existence of USTs or asbestos might be a legitimate question at a large number of commercial facilities, FWPCA or Clean Air Act compliance status issues will be less frequent. Still, even an unimproved piece of property may have regulatory issues. As an example, a potential purchaser considering manufacturing operations adjacent to a water body will need to investigate the cost necessary to obtain a FWPCA NPDES permit in this particular area.

Knowledge of the facility's activities or an initial inspection may indicate that sampling is necessary to determine whether environmental media have been impacted. Sampling for every conceivable chemical constituent at the property or facility is not practical. While a thorough discussion of sampling is beyond the scope of this article, it is important to note the attorney should, to the extent possible, ensure that the environmental consultant has tailored a sampling plan relevant to past or current activities at the facility. If, for example, the property has a history of degreasing activities, the sampling would include common degreasing constituents. In summary, a combination of intuition, judgment, and experience should be used to tailor the EA's scope of work to meet the client's needs in a commercial transaction.

EAs are performed by consulting firms with various types of technical expertise. Attorneys or clients considering the retention of an environmental consultant to perform an EA should consider a number of issues. The environmental consultant's qualifications are obviously critical. Different facilities or properties may require various types of technical expertise. A purchaser considering the acquisition of several older dry cleaning facilities

may need the services of a hydrogeologist if sampling for groundwater and/or soil contamination appears warranted. In contrast, a lessor attempting to determine the amount and type of asbestos in his or her building would need someone familiar with the substance and the different sampling methods.

A written contract between the client and consultant to detail the scope of work is always advisable. The scope of work is extremely important since the perception of attorneys, clients, and consultants as to what constitutes an adequate EA at a given property can vary. Misunderstandings can be disastrous.

Consider, for example, a purchaser considering the acquisition of a closed restaurant that retains an environmental consultant to perform a "Phase I" EA. The environmental consulting firm only conducts limited asbestos sampling in accessible areas pursuant to its understanding of what constitutes a "Phase I" EA. In contrast, the seller assumes that more extensive asbestos sampling will be performed because the building is scheduled to be demolished after closing.

The limited asbestos sampling is performed and the results are negative. The building is demolished. The Arkansas Asbestos Abatement Regulations are violated because there was apparently undiscovered friable asbestos behind a large stove. The seller and consultant disagree as to whether a "Phase I" should include the type of asbestos sampling that would have detected the material in this location. This issue would have been addressed if a detailed scope of work had been negotiated.

It must also be remembered that the EA process will generate information concerning the status of a given business' compliance with environmental laws and regulations. Efforts should be made to ensure the environmental consultant is contractually prevented from disclosing sensitive information. An exception to this restriction might reasonably include governmental requests for disclosure pursuant to the relevant federal and state environmental statutes. Consideration should also be given to whether possible protection of information through the attorney/client or work product doctrines is possible or desirable.

Finally, environmental consultants sometimes inadvertently use inappropriate and unnecessary verbiage in the EA report. Consequently, the EA report should be subject to review by the attorney and client prior to circulation.

(3) Strategy:

The motivation for a potential purchaser or a lessee to perform an EA prior to the acquisition of a facility is fairly clear. Neither the purchaser nor the lessee want to acquire a

property or facility without some understanding of current contamination or the future regulatory compliance costs.

An aggressive potential purchaser or lessee might also use an EA that simply identifies certain potential unquantified environmental problems to his or her advantage in negotiations with the seller or lessor. The negotiations for a warehouse/fleet fueling facility offers a possible example.

Suppose an initial EA cited the existence of older petroleum USTs and the failure to obtain a minor air permit for a paint booth emitting volatile organic contaminants. The buyer or lessee might propose consummating the transaction without additional assessment work if a substantial discount in price is provided. The buyer's rationale for taking this risk would be the belief that the USTs are covered by the Arkansas Petroleum Storage Tank Trust Fund and that the failure to obtain an air permit could be resolved without substantial penalties. A nervous or motivated seller might provide a discount to a buyer willing to take risks.

Sellers sometime perform EAs prior to marketing the property or facility in order to prevent a sophisticated buyer from utilizing environmental issues as leverage to discount the price. Advance knowledge and resolution of certain environmental issues may improve the seller's negotiating position. Certainly, identification and resolution of the minor air permit matter referenced in the previous example would have eliminated its use by the buyer as an argument for a price discount. Similarly, a confirmation that the USTs cited in the previous example were in compliance with the relevant regulations and consequently eligible for the Arkansas Petroleum Storage Tank Trust Fund would provide some comfort about UST spillage or leakage. Conceivably, the seller could also undertake testing and/or sampling to check for current or historical spillage or leakage. If these efforts confirm the absence of problems or result in a resolution, the seller would have a strong argument that a price discount is not warranted.

A seller undertaking an EA prior to marketing the property is foregoing the possibility of a potential purchaser sharing the cost of this work. More importantly, the seller should recognize that there are risks in undertaking an EA. The most serious is the possibility that the seller will discover environmental regulatory violations or contamination that must be reported to the federal or state environmental agencies.

The seller may also have to address these issues. If the seller continues these non-compliant activities after learning of them, the violations become knowing and penalties can escalate significantly. The same is true for failing to notify the relevant governmental authorities about reportable releases or contamination. Therefore, if the seller is considering the performance of an EA, he

or she must be prepared to address the violations or conditions discovered.

(4) Advantages to the Buyer (Summary):

The principal advantages to the buyer/investor from the environmental site assessment is determining any risks and liabilities associated with the site. Specifically, the environmental site assessment can quantify the:

(a) probability of a site problem;

(b) extent of the problem;

(c) potential financial liability; and

(d) cost of the cleanup.

With this information, the buyer can determine and negotiate the condition of the acquisition.

(5) Advantages to the Seller (Summary):

(a) The seller also benefits from an environmental site assessment of the property before a sales transaction is structured or before a buyer has been identified. Environmental problems discovered after the transaction has been structured at the insistence of the buyer puts the seller at a distinct disadvantage.

(b) Advance knowledge of site problems improves the seller's negotiating position. The seller may wish to redefine the property boundaries to leave out problem areas, or negotiate with the buyer for some type of cost sharing arrangement for the cleanup.

(c) If the seller conducts an environmental site assessment and finds a problem, it can be resolved and a resolution documented before a buyer is identified. Documentation that the site is clean is required by many informed buyers and can accelerate the sale.

(d) Of particular importance to the seller is reducing long-term liability and providing protection against future claims. By documenting site conditions at the time of sale, the seller protects against a buyer coming back at some future time requesting cleanup or a newly discovered problem on the site.

(6) The New ASTM Environmental Auditing Standard:

As previously described, Superfund provides a very limited defense for purchasers that acquire property with hazardous substances that neither knew nor had no reason to know of their existence. The American Society of Testing and Materials ("ASTM")

has attempted to define the necessary audit or review procedures to meet the CERCLA innocent landowner defense. It was also an attempt to put in writing good commercial and customary practices along with the facilitation of high quality environmental assessments.

ASTM has actually promulgated two specific procedures. One standard addresses phase one environmental assessments and the other, transaction screen process, is designed to be performed by the non-environmental professional. The ASTM standards outline the working principles of both the ESA and the transaction screen standard practices.

The transaction screen is primarily a questionnaire that consists of up to 23 questions. It is designed to be administered by either a purchaser of the property or the lender for the purchase at little or no cost other than personal time. Three parties complete the questionnaire:

* the owner of the property;
* the operator of the property; and
* the user of the transaction screen (the purchaser or the lender).

Each is required to answer certain questions with yes, no, or unknown. These questions include whether there are any underground storage tanks, burial of substances, etc.

Unlike the transaction screen standard, the ASTM standard for a phase one is required to be conducted by an environmental professional (i.e., someone who possesses sufficient training and experience necessary to conduct a site reconnaissance, interviews, and has the ability to develop conclusions regarding recognized environmental conditions). The ASTM phase one requires more information and is more costly.

B. Allocation of Risks:

Contracts, including those for the purchase and sale of commercial/industrial properties, should generally allocate risks between the parties. Environmental risks should be addressed in such allocation. (Note: These principles should also generally apply to leasing arrangements and lending).

1. Desired environmental risk allocations may sometimes be provided inadvertently by general provisions in existing contracts.

2. The direction and degree of environmental risk allocations in contracts may be dictated by the bargaining power of the parties (e.g., major oil company selling retail gasoline outlet to independent gasoline marketer).

3. The desirability of environmental risk allocations may be affected by cost implications (e.g., seller will indemnify buyer for all known and unknown environmental problems only if purchase price is increased by 25%).

C. Defining Risks:

Defining environmental risks and negotiating their allocation should be considered carefully in light of:

1. Evolving scope of environmental liability (e.g., development of federal and state laws which are continually focusing on new environmental problems).

2. Evolving regulatory requirements (e.g., development of federal and state regulatory programs that are continually altering what type of activities require a permit).

3. Identification of "new" risks:

(a) advances in detection technology (e.g., further advances in determining when natural resources such as ground water are contaminated);

(b) advances in determining and verifying cause/effect and health relationships (will friable asbestos in the commercial building setting be determined to cause health problems);

(c) changes in common law standards of care and liability (i.e., evolving strict liability standards). Courts may decline to interfere where interested and arguably, responsible parties have allocated liability by contract (see, e.g., Emhart Industries v. Duracell International, Inc., 665 F. Supp. 549 (M.D. Tenn. 1987); Mardan v. C.G.C. Music, Ltd., 804 F.2d 1454 (9th Cir. 1986). However, note Smith Land & Improvement Corp. v. Celotex Corp., 28 ERC 1083 (3rd Cir. 1988).

D. Objectives of the Parties:

1. Potential environmental concerns in a certain business transaction must be identified. Having identified these concerns, the objectives of the parties must be identified. Note that one party may have several roles. A purchaser, for example, may also be a borrower and a lessor.

2. Purchasers:

(a) A purchaser will want to buy a business, facility or property that it can cost effectively use as it has planned (e.g., what if the Corps of Engineers will not grant a 404 permit for the development of the land for purchase? Or it will grant the permit buy only if a number of acres is donated?).

(b) A purchaser will not want to accept liability for property contaminated by the seller without a price discount or contractual indemnification by the seller.

3. Sellers:

(a) A seller may wish to be able to address each potential concern of the potential buyer. Therefore, the seller may wish to engage in an environmental investigation prior to the property's sale.

(b) A seller might be liable for fraud or misrepresentation if it knows or should have known of an environmental problem which materially affects the transaction and does not disclose that condition to the buyer. The prudent seller may wish to perform an investigation and disclose what it knows.

(c) A seller might wish to address problems while it controls the site. Once control is lost, the seller may be ultimately liable but have no control over the scope or timing of the clean-up.

E. Protecting the Buyer:

1. The Buyer's Considerations:

Assuming that there is some contamination on the property to be purchased, the threshold question that must be addressed is whether the buyer should assume all responsibility for remediation of existing contamination or whether he should attempt to insulate himself from that responsibility.

(a) Require the Seller to Remediate the Contamination:

(i) Buyer by becoming owner of the property has become a party responsible for the cleanup of existing contamination under Section 107(a) of CERCLA or other various other federal and state environmental statutes.

(ii) Seller's remediation activities may interfere with the buyer's operations, with buyer in effect losing control over areas of his property. For example, major oil company sells three convenience stores to independent petroleum marketer. Each location has underground storage tank related contamination. The major oil company agrees to be responsible for cleanup. Unfortunately, several months after the transaction is closed, the independent petroleum marketer determines that the remediation methods chosen for each location will disrupt traffic flow for several months. It can be important to retain some control over remedy choices.

(b) Buyer Assumes Liability:

(i) This would be done in exchange for a better purchase price.

(ii) When the extent of the contamination is unknown, this is a very risky approach.

(c) Indemnification of Buyer:

(i) This is usually a more desirable approach allowing the buyer to remediate the contamination.

(ii) Advantages to the buyer include retaining control over the timing and implementation of the remediation activities and insuring that the activities are undertaken promptly and properly.

(iii) The buyer must be sure that the seller will have adequate assets to fulfill its indemnification obligation.

2. Environmental Baselines:

(a) The establishment of an environmental baseline is one mechanism for allocating responsibilities where the seller is to become responsible for the cleanup of prior contamination. In this situation a potential problem arises regarding the allocation of responsibility for pre-existing contamination versus responsibility for post-purchase contamination.

(b) The purpose of the baseline is to quantify the level of contamination on a property on the closing date so that the purchaser will be responsible for only increases in that level. Various sampling programs are available similar to those for the environmental site assessment.

(c) It should be recognized, however, that even the best environmental baseline can miss things. A soil sample taken in one area of the property indicates little, if anything about soil contamination 50 feet away. Moreover, contamination will migrate into groundwater and contamination levels will change over time. Thus, the purchaser is at risk as to any contamination that is not identified on the baseline because different contaminants or different levels of contaminants identified at a later date on this property will become the purchaser's responsibility. For these reasons, baselines are not a fail-safe approach for a buyer.

3. Leasing:

(a) Where the proposed acquisition is of unimproved real property, leasing instead of acquiring should be considered. Once a person becomes an "owner" under CERCLA, he is liable even

though he may never have disposed any hazardous substances on the property.

(b) Although lessees of property are likely to be considered "operators" under Section 107 of CERCLA, and therefore subject to liability, their responsibility for the property is more likely to be related to their activities during the period of their occupancy. Moreover, because there is an owner of the property which the federal or state government can pursue, it is more likely that the lessee will not be targeted for responsibility for past contamination. The situation will be even more confused when it involves underground storage tank problems.

(c) In a state with an environmental transfer statute, such as New Jersey's ECRA, a lessee may be required to decontaminate the property upon termination of the lease.

(d) Indemnity clauses in which a lessee agrees to indemnify and hold lessor harmless, even if the problem was caused by lessor's actions or fault, have been treated in three ways in the various states. Most states permit indemnity clauses in commercial leases, but some require clear, unequivocal language for the indemnity clause to apply to lessor's own negligence. A minority of states hold that such clauses are void as against public policy.

4. Disclosures, Representations and Warranties:

Representation and warranties will provide useful information regarding the other party's knowledge about the condition of the property. This information can be important in determining the scope of due diligence for a particular transaction. The objective of representations and warranties is to clearly and accurately communicate information. A party should avoid giving conclusions about existing conditions or the interpretation of technical information. Instead, the party giving the representation should describe the information upon which the conclusions are based and the source of the information. Where possible, the party to whom the representations are made should be required to have its own technical advisors to interpret the information.

(a) Representations and warranties regarding the environmental conditions may require the seller to disclose:

(i) all the hazardous substances it has generated, manufactured, or managed, sent off-site, or released or disposed of on-site;

(ii) knowledge of prior uses of the site and current site conditions;

(iii) possession of all necessary environmental permits;

(iv) compliance with applicable permits and environmental laws;

(v) actual or contingent environmental liabilities;

(vi) threatened or pending litigation, including response actions by the government or private parties;

(vii) knowledge of facts and circumstances that may give rise to future litigation;

(viii) the existence of environmental liens or superliens;

(ix) the condition of pollution control equipment;

(x) the presence of PCBs, asbestos and other toxic substances integral to equipment and buildings; and

(xi) the existence of wells, underground storage tanks, covered-over surface impoundments, and other "hidden" problems; and,

(xii) investigations by government agencies.

Some of these disclosures may not apply if only real estate is being purchased and not the ongoing business.

(b) The seller will usually be responsible for the condition of the property at the time of transfer. However, the seller should not permit the purchaser's post-transfer activities to increase the seller's existing or potential environmental liability. Accordingly, the purchaser's representations and warranties should include the following matters:

(i) the purchaser is aware of environmental conditions that have been disclosed by the seller;

(ii) the purchaser accepts the facility in its existing condition, ("as is" warranty);

(iii) the buyer has been given the opportunity to conduct an environmental assessment of the facility and either has conducted such an assessment or is determined that it is not necessary to conduct an assessment;

(iv) in the event the purchaser does not conduct an environmental assessment, he accepts and will be responsible for

all conditions of the facility, including conditions that would have been disclosed by such an assessment;

(v) the buyer will occupy, use, and operate the property in compliance with all applicable laws, including applicable health, safety and environmental laws;

(vi) the buyer will occupy, use, and operate the property in compliance with all applicable permits and approvals;

(vii) the buyer will not treat, store, dispose of, incinerate, or recycle any hazardous substances or solid wastes on the site except as described in an attached exhibit; and,

(viii) the purchaser will furnish seller copies of all environmental assessments, monitoring reports, analyses, and test results and related information upon the request of the seller.

(c) For various reasons, such as a careless or even deliberate misrepresentation by the seller, or financial condition of the seller, a prudent buyer should not rely solely on the seller's representation but should attempt to verify them through an environmental site assessment tailored to the circumstances.

5. Indemnification Provisions:

The purpose of an indemnification provision is to provide a contractual mechanism to reimburse the indemnified party in the event any of the events set forth in the agreement occur. However, there are several limitations on the usefulness of an indemnity. In many instances, environmental liabilities are not identified or assessed until many years after the occurrence of the events that created the liability. During this period, circumstances affecting the parties on the site may have changed substantially. For example, the indemnitor may have dissolved or become bankrupt.

Second, indemnification agreements can be difficult to enforce. In some cases the indemnitor may refuse to pay the claim that is the subject of the obligation without a lawsuit.

Third, the indemnitor will usually have no control over the property or facility that is covered by the indemnification agreement during the period of indemnification. The activities of a successor-owner may increase the amount of contamination on the site or the cost of the remedy, with the result in increasing the seller's percentage share of liability beyond his actual responsibility. Additionally, it may be impossible to determine whether the indemnitor's indemnification obligation should stop and whether the responsibility of the successor-owner should begin.

Issues Include:

(i) An indemnification for liabilities flowing from activities that took place while the seller held title to the property should be considered by a buyer.

(ii) The indemnification should cover all expenses, including attorneys' fees and related litigation expenses. A duty-to-defend provision may also be considered.

(iii) The buyer should be certain that the indemnification is given by a corporate entity which will have sufficient assets to meet the indemnification obligation.

(iv) Typically, if a buyer requests an indemnification provision, he can expect to be asked for an indemnity for any post-transfer activities. As long as the indemnity is carefully worded, this should not create unreasonable liability.

F. Protecting the Seller:

1. The Seller's Considerations:

(a) Liability from Prior Activities:

(i) The seller must ensure that he is not transferring title to property that may pose a significant risk of adverse health or environmental consequences to the buyer, his employees or the public at large.

(ii) As selling the property removes the property from the seller's control, its use may be changed from one that is compatible with its current environmental condition to one that is incompatible with its environmental condition. For example, a manufacturing site having low-level soil contamination may meed no remediation if it continues as a manufacturing site, but would if it becomes a grade school or a residential housing development.

(iii) It is therefore prudent to avoid transferring properties or businesses that pose a significant risk to public health or the environment, whatever the future use, unless provisions are put into the agreement to protect the seller.

(b) Liability from the Buyer's Activities:

(i) The seller must assure that any contamination from the buyer's activities on the property will not, in the future, be linked or attributed to him.

(ii) When a seller undertakes to dispose of property or a business which is associated real property, he should know the extent of contamination, if any, on the property. If he

does not know, he should undertake an environmental site assessment, similar to that described earlier, to determine if contamination is likely to exist.

2. Disclosure of Environmental Conditions:

As a seller, the first rule is to disclose all knowledge of the environmental condition of the property. Sellers are ill-advised to withhold information regarding the environmental condition of the property. Even where there has been no affirmative representation, some cases have held non-disclosure to be the basis for a cause of action premised upon failure to disclose a material fact.

3. Releases:

(a) An attempt should be made to secure a release from any environmental liability relating to the existing condition of the property:

(i) where a seller has undertaken substantial environmental remediation activities on a piece of property, or

(ii) where a seller knows the property to be free from environmental contamination.

(b) A buyer will be reluctant to grant a release as to the existing condition of the property, especially where the property is an old manufacturing facility and it is difficult to know the complete condition of the property.

4. Indemnification for Post-Transfer Activities:

(a) Where the seller believes that the buyer's post-transfer activities may degrade the environmental condition of the property, the seller should consider seeking an indemnification from any liability associated with these activities.

(b) If such indemnification is requested, then the buyer is likely to request an indemnification for pre-existing contamination. In determining the negotiating strategy, it must be recognized that the buyer will have a CERCLA cause of action against the seller with or without an indemnification provision.

(c) "As is" clauses have had varying amounts of success in releasing a seller from liability to the buyer for environmental conditions affecting the property. Some courts have held that an "as is" clause is not effective unless it expressly mentions the relevant environmental condition. Amland Properties Corp. v. ALCOA, 711 F. Supp. 784 (D.NJ. 1989). Other courts have held that they are warranty disclaimers and only serve to bar actions based on

breach of warranty. Wiegman & Rose International Corp. v. N.L. Industries, 735 F. Supp. 97 (N.D. Cal. 1990).

5. Indemnification to the Buyer:

(a) A seller should look for ways to limit his long-term liabilities under indemnification provisions. Because the seller's activities are not continuing on the property and liability is determined by existing conditions, the seller may be able to limit the extent of the indemnification.

(b) Limitations on liability under indemnification provisions may include:

(i) a time limitation;

(ii) limitations on the extent and types of losses (such as excluding consequential damages); and

(iii) a cap on total liability.

IV. AUDITS AND ENVIRONMENTAL COMPLIANCE

A. INTERNAL ENVIRONMENTAL AUDITS OR CORPORATE COMPLIANCE PROGRAMS

(1) Motivation Risks Related to Internal Audits:

The civil and criminal provisions of the federal and state environmental statutes are broad, convoluted and complex. Compliance with the regulatory provisions therefore demands a high degree of technical and legal sophistication. As a result, even a sophisticated and conscientious company will occasionally find itself out of compliance and at risk of criminal prosecution.

If some noncompliance is inevitable, there are two ways in which it may be identified. The first is through the performance of a compliance environmental audIt; the second is through a federal and state agency enforcement action. An environmental compliance audit might generally be defined as a "systematic, documented, periodic and objective review of facility operations and practices related to meeting environmental requirements." In the alternative, it is a method of verifying that regulations, company policy, and good operating practices are being obeyed. Self-policing and correction of environmental compliance, although sometimes costly, may in some cases be less expensive than compliance pursuant to agency enforcement actions. However, there are risks. The audits may uncover instances of historical violations, as well as existing violations or prospective problems. Such problems could require substantial expenditures to correct.

Once such a discovery is made, the company and its management face the risk of criminal sanctions, as well as civil or administrative enforcement, if the company chooses to continue to operate without correcting or abating the violations. Moreover, the audit may produce findings that, in some circumstances, must be reported to enforcement agencies under federal or state reporting requirements, which may in turn trigger enforcement action.

The failure to correct violations or report releases (as required by federal or state statutes) discovered during an environmental audit could subject certain employees and management to allegations that they "knowingly" failed to comply with federal and state environmental requirements. As will be discussed, the courts interpreting the federal criminal environmental liability provisions could conceivably hold certain management officials liable even if the employee that discovered the violation failed to bring it to their attention. Information that an environmental audit may produce is disseminated to personnel with the authority to act in a timely manner.

The threats posed by failing to address instances of noncompliance or reporting requirements are three-fold. First, the term "person" in federal criminal environmental statutes has been defined to include corporations. For example, the Resource Conservation and Recovery Act ("RCRA") defines a person as "an individual, trust, firm, joint stock, corporation . . . or any interstate body." 42 U.S.C. § 6903(15). The ability to prosecute a corporation as a "person" under the "collective knowledge" doctrine has reduced the requisite intent necessary to sustain a conviction under the environmental statutes requiring knowing conduct. This doctrine allows the collective knowledge of a corporation's employees, acquired within the scope of their employment to be imputed to the corporation. See 1K.Brickey, Corporate Criminal Liability § 40:05 (1984). Therefore, a corporation can be convicted for a knowing violation even though no one employee had actual knowledge of all elements of the violation.

Second, although federal environmental statutes generally require some degree of intent for criminal liability, the government need only demonstrate that a person knew what he or she was doing, and that they did it voluntarily, and not accidentally. Normally it is not necessary to show that he or she actually knew what the law required or that he or she acted with the specific purpose of violating the law. See, e.g., United States v. Hayes Int'l Corp., 786 F.2d 1499 (11th Cir. 1986). In Hayes, the court upheld a plant employee's RCRA conviction, finding that so long as there is knowledge that the waste is not innocuous, the knowledge requirement is satisfied. Therefore, the government was not required to prove knowledge of its classification as hazardous nor knowledge that a permit was required for its disposal.

Third, the targets for environmental criminal prosecutions are often individual employees of the corporation, in addition

to the corporate entity itself. Such targeted individuals include not only environmental engineers, but also corporate officers with broad responsibilities for development of corporate environmental policies and capacity to influence compliance with company policies and procedures. In targeting management for criminal prosecution, the federal government increasingly relies upon the "responsible corporate officer" doctrine to define and prove individual culpability. This doctrine allows the government to prove "knowing conduct" inferentially, based upon the defendant's relative position in the company, coupled with failure to learn certain facts or take appropriate action.

This doctrine originated with United States v. Dotterweich, 320 U.S. 277 (1943), a non-environmental case (food and drug) in which a corporate president was criminally charged even though there was no evidence that he was aware of the unlawful conduct. In Dotterweich, the United States Supreme Court held that "[t]he offense is committed . . . by all who do have such a responsible share in the furtherance of the transaction which the statue outlaws," and suggested that corporate officers have a duty to learn the facts if ignorant of them. More recently, the Supreme Court reaffirmed that doctrine in another food and drug case, United States v. Park, 421 U.S. 658 (1975), where it upheld a criminal conviction of a corporate officer under the Federal Food, Drug and Cosmetic Act, holding that the government need only prove that the manager had the responsibility and the power to prevent or correct a violation of the statute.

This prosecutorial tool, imputing knowledge of legal violations to responsible managers where direct evidence is lacking, is now being used to prosecute officers under various environmental statutes. See, e.g., United States v. Johnson & Towers, Inc., 741 F.2d 662 (3d Cir. 1984); United States v. Frezzo Bros., 602 F.2d 1123, 1130 n.11 (3d Cir. 1979) (in upholding criminal convictions of corporate officers charged with federal Clean Water Act ("CWA") violations, the court noted that the government argued the case on the responsible corporate officer doctrine and that it perceived no error in the trial court's instruction on this theory).

Appellate courts have applied this doctrine in an environmental setting. In Johnson & Towers, the Third Circuit upheld the criminal convictions of a plant foreman and service manager, finding that the RCRA penalty provisions apply to "responsible corporate officers," who include employees as well as operators, "if they knew or should have known that there had been no compliance with the permit requirement . . . ." Id. at 664-65. The broad application of the "responsible corporate officer" doctrine is supported by the criminal provisions of certain federal and state environmental laws. CWA, § 309(c)(6), 33 U.S.C. § 1319(c)(6) (1988) (expressly provides for criminal liability for "any responsible corporate officer") Clean Air Act ("CAA") § 113(c)(3), 42 U.S.C. § 7413(c)(3) (1988) (expressly provides that penalty provisions apply to "any responsible corporate officer"); Clean Air Act Amendments of 1990,

Pub. L. No. 101-549, § 701, 104 Stat. 2399, 2677 (codified at 42 U.S.C.A. § 7413(c)(6) (West Supp. 1991)) ("the term 'person' includes . . . any responsible corporate officer").

More recently, however, in United States v. MacDonald & Watson Oil Co., 933 F.2d 35, 55 (1st Cir. 1991), another RCRA enforcement case, a different appellate court declined to extend the reach of the responsible corporate officer doctrine to permit knowledge to be inferred solely from the defendant's corporate position. In MacDonald & Watson, the First Circuit held that "a mere showing of official responsibility" does not by itself constitute sufficient proof of culpability with regard to criminal offenses that have an express "knowledge" or scienter requirement. Distinguishing Johnson & Towers, where the issue involved knowledge of the law, i.e., permit requirements, the MacDonald & Watson court held that a company officer could be held liable under the doctrine only if the government proved knowledge of facts relative to the violation charged. However, the court acknowledged that such knowledge could be proven inferentially by circumstantial evidence, including "willful blindness" to the facts.

The Fourth Circuit's decision in United States v. 912 F.2d 741, 748-49 (4th Cir. 1990), has been one of the more stringent applications of the responsible corporate officer doctrine. The defendants in Dee were civilian engineers employed to develop chemical warfare systems for the Army. Gepp, a chemical engineer, was responsible for operations and maintenance at the facility. Dee and Lentz were Gepp's superiors. As heads of their respective departments, the defendants were responsible for ensuring that provisions of various company compliance policies, as well as the RCRA requirements, were fulfilled within their departments and that their subordinates were aware and in compliance with those regulations. The district court found all three guilty of multiple violations of RCRA for illegally storing, treating, and disposing of hazardous waste.

The defendants argued that they did not knowingly violate RCRA. The defendants claimed that they did not know that violation of RCRA was a crime and that they were unaware that the chemicals they managed were hazardous. The court held that ignorance of the law is no defense and, more specifically, that the government did not need to prove the defendants knew of the violations. It was enough that they knew of the generally hazardous nature of the chemicals they were handling. Applying the reasoning of the public welfare statutes to RCRA, the court stated that "where . . . dangerous or deleterious devices or products of obnoxious waste materials are involved, the probability of regulation is so great that anyone who is aware that he is in possession of them or dealing with them must be presumed to be aware of the regulation."

Defendant Gepp contended that there was insufficient evidence that he directed the storage or disposal operations. He

asserted that "[s]loppy storage procedures is [sic] not a crime." The court strongly disagreed, stating "[n]egligent and inept storage of hazardous waste is one of the evils RCRA was designed to prevent, and § 6928(d) makes such egregious behavior a crime." The court found evidence that Gepp was in charge of operations at the plant, had originally ordered placement of the hazardous chemicals in a storage shed, had repeatedly ignored warnings about the hazardous condition of chemicals that were improperly stored, and had made no effort to comply with RCRA regulations. The court found this evidence sufficient for the imposition of criminal liability under RCRA.

Notwithstanding the circumscribed application of the responsible corporate officer doctrine in MacDonald & Watson, the responsible corporate officer doctrine remains available to pursue corporate officers with direct, or even indirect responsibility for environmental matters.

(2) Federal Enforcement Positions on Compliance Environmental Auditing:

A comprehensive environmental compliance audit program may reveal instances of noncompliance. The various statutes require that certain violations or events be reported. However, many do not have to be brought to the agency's attention. Therefore, it is appropriate to review the EPA, Department of Justice ("DOJ") and the United States Congress' (most recent statement) views on the treatment a company should expect if a violation is discovered, voluntarily reported, and expeditiously remedied.

(a) EPA Environmental Auditing Policy (Summary):

EPA issued a policy statement on environmental auditing effective July 19, 1986. 51 Fed. Reg. 25004 (1986). The interim policy statement was published in the Federal Register on November 8, 1985. 50 Fed. Reg. 46504-08 (1985). The policy was summarized by EPA as follows:

> It is EPA policy to encourage the use of environmental auditing by regulated entities to help achieve and maintain compliance with environmental laws and regulations, as well as to help identify and correct unregulated environmental hazards. This policy statement specifically:
>
> *Encourages regulated entities to develop, implement, and upgrade environmental auditing programs;
>
> *Discusses when the Agency may request audit reports (it will not routinely do so);

*Explains how EPA's inspection and enforcement activities may respond to regulated entities' efforts to assure compliance through auditing;

*Endorses environmental auditing at federal facilities;

*Encourages state and local environmental auditing initiatives; and

*Outlines elements of effective audit programs.

51 Fed. Reg. 25004 (1906).

The EPA policy statement cautions that "the existence of an auditing program does not create any defense to, or otherwise limit, the responsibility of any regulated entity to comply with applicable regulatory requirements."

(b) DOJ Guidance (Summary):

In an effort to provide a framework for determining when to pursue criminal sanctions and to provide the regulated community with a "sense of how the federal government exercises its criminal prosecutorial discretion . ." DOJ issued in 1991 a guidance entitled Factors in Decisions on Criminal Prosecutions for Environmental Violations in the Context of Significant Voluntary Compliance or Disclosure Efforts by the Violator ("Guidance"). Specifically, the Guidance articulates the factors that the DOJ will consider in deciding whether to initiate an environmental criminal prosecution and whether circumstances exist that warrant prosecution of a lesser charge. It also provides a number of hypothetical examples demonstrating how the criteria should be applied. The Guidance is relevant since it specifically considers the scenario in which a regulated facility voluntarily discloses a violation.

The Guidance indicates that it is the DOJ's policy "to encourage self-auditing, self-policing and voluntary disclosure of environmental violations by the regulated community by indicating that these activities are viewed as mitigating factors in the DOJ's exercise of criminal environmental enforcement discretion." In other words, criminal prosecutions should not create a disincentive for companies undertaking internal audits and disclosing the results. The Guidance articulates six factors the DOJ should consider in determining whether or not and how to prosecute companies that disclose violations. It expressly provides that no one factor will likely be dispositive in any given case and other relevant factors, including those not contained in the Guidance, may be applicable in a given situation.

The first of three main factors is whether the person made "a voluntary, timely, and complete disclosure of the

matter under investigation." Specifically, the Guidance appears to give weight to persons who promptly come forward after discovering a violation and who provide information that aids the government's investigation. Disclosure that is mandated by a statute, regulation, or permit is not considered voluntary.

The degree and timeliness of the violator's cooperation is the second main factor considered by the DOJ. Cooperation, as expressed in the Guidance, pertains to the person's willingness to assist the government in its investigation, including providing all relevant data and information. Specific examples of the types of information the DOJ may seek include the results of internal investigations and the names of all potential witnesses.

The third main factor is "the existence and scope of any regularized, intensive, and comprehensive environmental compliance program; such a program may include an environmental compliance or management audit." The recognizes that various audit or compliance programs exist, but emphasizes that the programs must include sufficient measures to identify and prevent future violations and must have been established in a timely manner.

Specifically, DOJ will look to see: (1) whether there was a corporate policy emphasizing compliance with all environmental requirements; (2) whether safeguards existed that exceed those required by law to prevent violations from occurring; (3) whether regular audit procedures, with sufficient safeguards to ensure the audit's integrity, were followed; and (4) whether the company provided sufficient resources for an effective audit program and was committed to respond expeditiously and effectively to the conditions discovered by the audit.

In addition to the three main factors, the Guidance describes three other criteria that may be relevant in a particular case. The first criterion focuses on the company's history of noncompliance. A company with a history of noncompliance "may indicate systemic or repeated participation in or condonation of criminal behavior." The second criterion relates to whether the company has an effective disciplinary system, which not only punishes offenders but also alerts other employees that criminal conduct is unacceptable. The third criterion is whether and how quickly the company corrected the violation. In fact, the Guidance indicates that "considerable weight" will be given to those persons who undertake prompt, good-faith efforts to reach environmental compliance agreements.

To further assist federal prosecutors (and the regulated community), the Guidance includes several hypothetical examples of how the Justice Department will apply the factors in evaluating environmental cases. The examples encompass both ends of the spectrum--from situations when criminal prosecution should not occur to situations when the government should pursue the maximum

penalty. The Guidance notes that each case will differ not only in which factors are present but also the degree to which the criteria are satisfied.

The "ideal hypothetical case" described in the Guidance is one involving a company with an effective compliance program with established policies and training programs that regularly conduct compliance audits. Upon discovery of a violation, the company undertakes an internal investigation to confirm the information about a potential violation discovered by the audit and discloses all relevant information concerning the violation to the government, including the names of those involved in the criminal activities.

It then attempts to correct any false information previously submitted to the government and disciplines the employees involved in the criminal conduct. Finally, the company promptly and completely remedies the violation and reviews its compliance program to determine how the violation "slipped through the cracks." In this situation, the Guidance indicates that the company "would stand a good chance of being favorably considered for prosecutorial leniency, to the extent of not being criminally prosecuted at all." The Guidance provides, however, the degree of leniency will depend on all relevant factors, including those not addressed in the Guidance.

The Guidance also provides examples of a situation when prosecutorial leniency would be remote, when prosecution of a lesser charge may occur, or when pursuing employees instead of the company may be appropriate. It concludes by providing that "mitigating efforts made by the regulated community will be recognized and evaluated. The greater the showing of good faith, the more likely it will be met with leniency. Conversely, the less good faith shown, the less likely that prosecutorial discretion will tend toward leniency."

(c) Clean Air Act (1990 Amendments):

The Joint Explanatory Statement of the Committee of Conference for the CAA Amendments of 1990 contains hortatory language specifically intended to encourage owners and operators of sources subject to the Clean Air Act to conduct self-evaluations and self-audits. 136 Cong. Rec. 13,101 (daily ed. Oct. 27, 1990). The Joint Statement provides in part:

> Nothing in subsection 113(c) is intended to discourage owners or operators of sources subject to this Act from conducting self-evaluations or self-audits and acting to correct any problems identified. On the contrary, the environmental benefits from such review and prompt corrective act ion are substantial and section 113 should be

read to encourage self-evaluation and self-audits.

Owners and operators of sources are in the best position to identify deficiencies and correct them, and should be encouraged to adopt procedures where internal compliance audits are performed and management is informed. Such internal audits will improve the owners' and operators' ability to identify and correct problems before, rather than after, government inspections and other enforcement actions are needed.

The criminal penalties available under subsection 113(c) should not be applied in a situation where a person, acting in good faith, promptly reports the results of an audit and promptly acts to correct any deviation. Knowledge gained by an individual solely in conducting an audit or while attempting to correct any deficiencies identified in the audit or the audit report itself should not ordinarily form the basis of the intent which results in criminal penalties.

(d) December 22, 1995 EPA Policy Statement (60 Fed. Reg. 66706). Policy Statement on incentives provided for voluntary disclosure of violations. Include reduction of gravity component of civil penalties and no recommendation for criminal prosecution. Addresses requests for audits.

(e) Arkansas and Other State Environmental Audit Privileges:

See appended outline.

(3) Protecting Audit Information:

For various reasons, companies may want to keep some or all of the information generated by the environmental compliance audit confidential. Besides the federal or state environmental requirements, companies could be required to disclose information developed during the course of an environmental compliance audit in two instances.

First, the EPA or state environmental enforcement agency could require submission of information under the various environmental statutes that authorize these agencies to discover information and to compel record keeping, pollution monitoring and reporting, and access for agency inspectors. The information provided the federal or state agency pursuant to these authorities could result in an enforcement action or mandate for remediation. However, as a practical matter, agency access to such information may not

always be a concern, since the environment compliance audit will deal with many areas that the federal and state regulations already require to be reported to agencies, such as permit excursions.

EPA stated in its audit policy that it would not routinely request the results of environmental compliance audits. See 51 Fed. Reg. 25, 004 (July 9, 1986). However, EPA specifically reserved the right to request an audit (or relevant portion of an audit) whenever necessary for an enforcement action and particularly when pertinent to a criminal investigation.

DOJ has sought to use environmental audit information in two recent cases, United States v. Dexter and United States v. Weyerhaeuser. Walker Trust in Auditing, But Verify, Envt'l. Forum (Jan./Feb. 1992) at 41 ("hereinafter "Walker"). The author of the previously cited article, an EPA enforcement attorney, states:

> [W]ith the exception of audits initiated as a condition of consent agreements or decrees, the EPA, in fact, rarely ever seeks to obtain or use any information contained in audit reports.

Walker at 41.

The second manner in which an environmental compliance audit could become public is through discovery requests and civil litigation brought by private entities. Parallel proceedings against a corporation and its officers can occur consecutively or simultaneously. Proponents in the various actions often request disclosure of documents and information.

(a) The Limited Strategies to Protect Confidentiality:

(i) Attorney-client privilege:

To obtain the benefit of the attorney-client privilege for an environmental audit, a company must perform the environmental audit as part of legal advice from an attorney, rather than as a routine management analysis. There is no clear test for a claim of the privilege; rather, courts evaluate privilege claims on a case-by-case basis. The purpose of the attorney-client privilege, which attaches to corporations and individuals, is to encourage clients to make full and frank disclosure to their attorneys so that the attorney may render sound legal advice. The privilege extends to communications from as well as to the attorney; therefore, it protects both the client's furnishing of information and the attorney's furnishing of legal advice.

The traditional elements of the privilege that must be present for a communication to be held confidential are:

(1) the communication must be made in order to obtain legal advice;

(2) the communication must be with an attorney;

(3) both the client and the attorney must maintain the confidentiality of the communication; and

(4) neither the client nor the attorney may have waived the privilege.

United States v. United Shoe March. Corp., 89 F. Supp. 357, 358-59 (D. Mass. 950). Because courts strictly construe privilege claims, companies must plan and initiate the environmental auditing process so that the requisites of the attorney-client privilege exist for all communications that are desired to be kept confidential.

In United States v. Chevron, 1989 U.S. Dist. Lexis 12267 at 17 (E.D. Pa. Oct. 16, 1989), for example, the court rejected a claim of attorney-client privilege and ordered production of environmental audit reports, finding that Chevron had failed to demonstrate that its in-house counsel had been acting in a legal capacity when she participated in the audit or that the communication pertained primarily to legal assistance.

(ii) Work-product privilege:

(A) Protected material:

The work-product privilege provides a second potential means of protecting information. An attorney's legal analysis of whether a facility may have violated an environmental statute or regulation is one example of work-product in the environmental context.

The privilege belongs to and protects the interests of both the client and the attorney, either of whom may assert it. Federal Rule of Civil Procedure 26(b)(3) codifies the elements of the privilege, which provides qualified protection for documents, notes, and other tangible things prepared for or by an attorney "in anticipation of litigation," as well as for "mental impressions, conclusions, opinions, or legal theories of an attorney." Most courts have held that the work-product privilege also protects the work of consultants hired by an attorney on the client's behalf, although the work may receive the lesser protection afforded documents.

The purpose of this privilege is to provide the degree of privacy necessary for the attorney to prepare the client's case vigorously. Upjohn Co. v. United States, 449 U.S. 383, 398-99 (1981) (quoting Hickman v. Taylor, 329 U.S. 495, 511 (1947)). For this reason, the work-product privilege protects a

broader category of material than the attorney-client privilege. Despite this broader coverage, the work-product privilege is probably less useful in protecting environmental compliance audits and supporting documents than the attorney-client privilege. Federal Rule of Civil Procedure 26 permits the disclosure of documents and tangible items that constitute an attorney's work-product upon a showing of substantial need and the inability to obtain the equivalent without undue hardship. Moreover, the privilege only applies when litigation may reasonably be foreseen, a condition which might not be present in some instances.

The privilege offers greater protection for work-product that reflects the attorney's mental processes. So-called "opinion" work-product includes memoranda or notes based on recollection and evaluation of oral interviews. To the extent that an environmental audit revealed an attorney' s mental processes, such as evaluations of employee oral statements or questionnaire responses, then it would constitute opinion work-product.

To maximize the opportunities for protection of the environmental audit and documents under opinion work-product, an attorney may actually have to prepare the materials. Thus, if a company wishes to establish work-product protection for the environmental audit, the company should structure the review so that an attorney gathers as much of the information as possible through employee interviews, and records the information in handwritten notes and memoranda. Whether or not a company deems such effort worthwhile, is of course a business decision that will be driven by the perceived risks of the environmental audit of a particular facility.

(iii) Self-evaluative privilege:

The third basis for a claim of confidentiality is the limited protection that may be afforded the self-evaluative portion of environmental audits. This judicially created privilege might protect a company's candid self-evaluation of compliance with state or federal laws. The privilege protects only self-evaluative elements of reports, not the factual material itself. In addition, a showing of exceptional necessity can overcome the privilege. Courts generally decide a claim used on this privilege by balancing the public policies favoring and opposing disclosure.

The self-evaluative privilege is still evolving from its first recognition in Bertice v. Doctor's Hospital, Inc., 50 F.R.D. 249 (D.D.C. 1970), aff'd mem., 479 F.2d 920 (D.C. Cir. 1973), and remains largely undefined. The courts generally require that three elements be present:

(1) the information to be shielded from discovery results from a critical self-analysis by the party seeking protection;

(2) the public has a strong interest in preserving the free flow of the type of information sought; and

(3) the information must be of the type whose flow would be curtailed if discovery were allowed.

One might argue that the self-evaluative privilege is strengthened by the EPA's recognition in its Auditing Policy, that regulated entities need to self-evaluate environmental performance with some measure of privacy. See, e.g., J. Crist, Reporting, Recordkeeping and Disclosure Requirements for An Environmental Audit, 5 (1989). However, EPA has not guaranteed it will not request environmental audit information.

This issue has been addressed in the environmental audit context in at least one unreported decision. In United States v. Dexter Corp., a court ruled that the government was entitled to obtain certain documents even though they were claimed to be shielded by the self-evaluation privilege. Walker at 41. The court found that the privilege would violate public policy against discharges of wastes and frustrate the government's enforcement of the Clean Water Act.

Endnotes:

1. Ark. Code Ann. § 8-7-901 et seq.

2. CERCLA responsible parties are listed in Section 107(a). 42 U.S.C. § 9607(a).

3. See generally 40 C.F.R. § 280 et seq.

4. See generally 42 U.S.C. § 7671 et seq.